

the long and short- term of it demos finance on the kay review

Andrew Lodge
Andrew Freeman

September 2012

DEMOS

THE LONG AND SHORT-TERM OF IT: DEMOS FINANCE ON THE KAY REVIEW

Andrew Lodge

Andrew Freeman

28 September 2012

Open Access. Some rights reserved.

As the publisher of this work, Demos wants to encourage the circulation of our work as widely as possible while retaining the copyright. We therefore have an open access policy which enables anyone to access our content online without charge. Anyone can download, save, perform or distribute this work in any format, including translation, without written permission. This is subject to the terms of the Demos licence found at the back of this publication. Its main conditions are:

- Demos and the author(s) are credited
- This summary and the address www.demos.co.uk are displayed
- The text is not altered and is used in full
- The work is not resold
- A copy of the work or link to its use online is sent to Demos.

You are welcome to ask for permission to use this work for purposes other than those covered by the licence. Demos gratefully acknowledges the work of Creative Commons in inspiring our approach to copyright. To find out more go to www.creativecommons.org



Published by Demos 2012
© Demos. Some rights reserved.

Third Floor
Magdalen House
136 Tooley Street
London SE1 2TU

T 0845 458 5949
F 020 7367 4201

hello@demos.co.uk
www.demos.co.uk

ABOUT THE AUTHORS

Andrew Lodge is a former advisor on economic and financial policy at HM Treasury. From October 2012 he is an Associate Principal at McKinsey & Company in London.

Andrew Freeman is Director of Demos Finance, founder of Cambridge Research Associates and a Risk Fellow at the Centre for Risk Studies, Judge Business School, University of Cambridge.

EXECUTIVE SUMMARY

At the end of July 2012, the Department for Business, Innovation and Skills published the Final Report of the review by John Kay into UK equity markets and long-term decision-making. The report looks at how well savings are translated into equity investments in UK-listed companies' equity, an issue of great importance both to the functioning of the economy and to the distribution of the proceeds of growth between executives, financiers, investment managers and savers.

This Demos Finance report summarises and assesses the Kay Review's analysis and recommendations, and asks: how much difference can the Kay recommendations make, and what else needs to happen for there to be change in the UK investment system? ¹

The basic question of whether the roles and behaviours of UK financial institutions lead to poorer outcomes for the UK economy is hardly a new one. Indeed, there have been many similar reviews in past decades, since the MacMillan Committee in the 1930s.² Since deregulation of finance in the 1980s, however, there has been evidence of an increasingly short-term approach to investment by asset managers, pension funds and insurance companies. In light of the current economic and financial crisis, now seems a good time to re-examine this question.

The analysis

The Kay Review outlines the evidence for short-termism. Business investment as a percentage of GDP has declined in many countries, and there is a lower spend on research and development (R&D) investment in the UK than other major countries. Increased mergers and acquisitions (M&A) transactions and evidence of 'hyperactivity' by corporate executives, or over-trading by investors, all create short-term outcomes throughout the investment chain. The Review teases out the complex reasons for this, in particular:

- Corporate decision-making has suffered from 'financialisation', with corporate executives giving greater focus to the current

share price than is warranted, rather than strategic operational concerns. This has been based on a theory of efficient markets that is flawed due to organisational frictions and cognitive biases.

- The function of equity markets is now more about controlling corporations, rather than providing finance for new investment. But there has not been good quality engagement between corporate executives and shareholders on long-term strategic issues, exacerbated by the current process for reporting and giving earnings guidance. Better engagement – rather than always selling shares at the first sign of trouble – would improve outcomes.
- The lengthening chain of ownership has meant misaligned incentives and moved asset managers (and others) away from the long-term interests of savers and companies. There is a proliferation of agents, and there is a tendency to judge whether markets are working well in terms that relate to market participants – e.g. liquidity, price discovery, transparency – rather than the long-term benefit of companies or savers.
- Throughout this chain, the concern of all agents is *short-term relative* performance, even though the concern of savers is *long-term absolute* performance. This leads asset managers to stick close to the benchmark (‘closet-tracking’), and limits the extent of engagement with companies.

The recommendations

The Kay Review analysis makes many points that directly challenge existing market beliefs and practice. It can seem surprising, therefore, that the recommendations seem to be relatively light-touch. That may be because there is already so much regulation of behaviour in investment markets, with unintended negative consequences. The Kay Review recommends no major structural change recommended akin to the Vickers Commission on Banking,

but rather seeks to empower and encourage asset managers to act in a longer-term way.

The main recommendations are:

- **An expanded Stewardship code**, to broaden the definition of stewardship and focus on strategic issues, not just corporate governance. The hope is that this will build a culture of trust and respect.
- **Good Practice Statements for company directors, asset managers and asset holders** that promote stewardship and long-term decision making, rather than a purely financial focus. For asset managers, the Good Practice Statement should include guidance towards more concentrated portfolios, less requirement for liquidity, less emphasis on short-term relative performance and closer engagement between asset managers and companies.
- **An investors' forum** to facilitate collective engagement by investors in UK companies. The Review also argues that companies should consult their major long-term investors over major board appointments, a process which could potentially be managed through such an investor forum.
- **Better company reporting processes.** The recommendations also looked to encourage companies to break out of the mode of responding to short-term market demands. The most obvious recommendations are that mandatory quarterly reporting obligations be removed, and more generally that companies should look to disengage from the process of managing short-term earnings and give high quality, succinct narrative-reporting.
- **Revised fiduciary standards, with a wider interpretation of long-term value.** Fiduciary standards should apply to all relationships in the investment chain, and the Law Commission should review the legal concept of

fiduciary duty to address uncertainties and misunderstandings on behalf of trustees and advisers.

- **More long-term remuneration for corporate executives and investment managers.** Both directors' remuneration and that of asset managers should be structures to relate to sustainable long-term business performance, with incentives provided only in the form of company shares to be held at least until after the executive has retired from the business, or the manager no longer runs the fund.
- **Disclosure of all costs.** Current disclosure underestimates the costs. Trading costs, for example, are often not disclosed. The Review recommends that asset managers should disclose all costs, including estimated transaction costs, and performance fees. Furthermore, all income from stock-lending should be disclosed and rebated to investors.

Assessment and points raised

Will these changes make enough of a difference? Perhaps, but there are causes for concern.

First, the recommendations are aimed at a range of parties, in particular the asset management industry. The development of Good Practice codes and an investor forum will most likely need significant input from the asset management industry and – potentially – will open up avenues for the proposals to be neutered or buried.

Second, how will the central recommendation of Good Practice codes work without enforcement? Fiduciary duties may set a minimum level of behaviour for agents and asset managers, but an industry code may not be enough of an incentive for asset managers to behave differently. And if asset managers do not change, it seems unlikely that the changes in culture demanded of corporate executives will also take place.

A third concern is that there is little discussion of end investors, particularly pension trustees and retail investors. A powerful defence of the asset management industry against the charge that they fail to act in the long-term interests of savers is that they follow the needs of the client. Is a focus on pension fund management and retail investors necessary for change? It remains to be seen.

Another concern is that this will become mired in party political and inter-departmental wrangling. The Kay Review was located in the Business Innovation and Skills (BIS) department, under Vince Cable, yet HM Treasury retains oversight of financial regulation. The Chancellor, George Osborne, a Conservative, may be happy to see Vince Cable, a Liberal Democrat, pursue these measures, but not give the support required from the Treasury for reforms to succeed, especially given the current policy focus on short-term deficit reduction and immediate growth measures.

The final concern is that existing market beliefs, for example on efficiency or liquidity, are powerfully entrenched and hard to overcome. Not least, they suit the interests of many market participants.

The reaction of the *Financial Times* Lex column to the Kay Review publication gives a flavour of the difficulty.³ Lex came out with a standard defence of current practice and beliefs: John Kay's vision was 'old-fashioned' and 'flawed'; selling a share is better than shareholder engagement (even though the Kay Review presented compelling arguments for why engagement might, in some cases, be better); and ending quarterly reporting was bad as it would prevent investors from making informed decisions (even though the Review gave good arguments that there was too much disclosure, and that additional information undermines long-term objectives).

Areas for further exploration

Beyond the Kay Review analysis, there are some areas which the government and City participants could consider further to give investment management better outcomes for savers and companies. Some suggestions are:

- 1) **Private equity ownership models?** Kay notes that the best form of long-term investing is concentrated ownership, with engagement from managers. Several models of company ownership do this currently (e.g. long-term family ownership; bank-controlled boards; Warren Buffett), and private equity in particular employs this model. There are clear problems with private equity: high fees, too much leverage, and the average returns to pension funds after fees have been poor. But the evidence is that the best private equity funds do achieve better company operating performance.⁴ Are there ways to bring the benefits of concentrated private ownership to public institutional investors? More work could be done here.
- 2) **Changes to voting rights?** Should proposals for additional voting rights for long-term investors be promoted more strongly? The Review rejected these in favour of an approach of trying to inculcate stewardship in investors. After all, UK companies are legally free to create differential share classes with different voting rights if they would like. But the UK is unusual in having a very strong presumption against dual-class shares in companies.⁵ Perhaps a greater diversity of corporate legal structures would allow UK corporations that require a long-term approach to have greater success.
- 3) **How to address over-trading and closet tracking?** What more needs to be done to address over-trading and closet tracking by investment managers? Disclosure of trading costs will help. But better statistics could be publicised by regulators on the benefits and costs of active fund management versus tracking products.
- 4) **How will a new definition of fiduciary duty be developed?** There seems to be a fair degree of agreement that one problem is the definition of fiduciary duty for investors and trustees, or the interpretation of that duty. How will this be changed? Who will champion this change? The Review is, understandably, light on details here.

Whether the reforms will succeed, however, depends on having firm recommendations, championed by government, media commentators and end investors, not just taken forward by market participants themselves. How this will work – and whether it will work – remains to be seen.

INTRODUCTION

Particularly in the matter of investment have our financial institutions been weak... Though industry should in no way be managed by the banks, both industry and finance would benefit from a closer relationship between British industry and the City of London.

The Report of the MacMillan Committee, 1931

The social object of skilled investment should be to defeat the dark forces of time and ignorance which envelop our future...the actual object of most skilled investors is 'to beat the gun'...to outwit the crowd...to pass on the bad half-crown to the other fellow...

John Maynard Keynes, *The General Theory*, 1936

I do not doubt for one moment that deep-seated short-term attitudes are prevalent in our affairs; or that this is one important strand in understanding why we as a nation have performed less well than many of our competitors. Such attitudes have led us to invest less than we might in technology and advanced means of production.... [and] have led us to place far too great an emphasis on comparisons of near-term financial results in judging our companies, instead of considering the strength of management and its underlying strategy.

Michael Heseltine, Budget Debate, 22 March 1993⁶

In 1988, two of the UK's top academic economists co-published an article in *Economic Policy* on 'Regulatory Reform in Britain', exploring changes in regulation underway in many UK industries in the 1980s, particularly in financial and professional services and utilities such as gas and telecommunications.⁷ The wide-ranging article identified three kinds of market failure which could justify regulation – externalities, market power or asymmetric information – and proposed a distinction between regulating structures and regulating conduct or firms' behaviour. The authors argued that

where regulators lacked the information to spot undesirable conduct, structural regulation of which activities firms could engage in was often better than trying to regulate behaviour. The paper was, said one commenting Oxford academic, ‘a considerable accomplishment in this area’.⁸

Roll forward almost twenty-five years, and those same two economists, John Vickers and John Kay, have been given prominent roles in the task of redesigning the UK’s financial markets. John Vickers’ Banking Commission reported in September 2011 and had a clear, immediate structural recommendation: the ring-fencing of investment activities from retail banking. The Kay Review addresses problems in UK equity markets, the crucial link between people’s savings – particularly in the form of pensions – and company investment. Historically, equity markets have been a crucial factor in spurring economic growth by providing investment for innovation and technological advances yet, arguably, currently these markets are rife with short-termism and misaligned incentives, which give poor economic outcomes. Addressing these problems was the task given to John Kay.

Will John Kay’s work have as much impact as John Vickers’ Banking Commission? The two reviews have necessarily been very different. The Vickers Commission was launched in the glare of media scrutiny, with many more resources, and with the problem being arguably clearer: there is little argument that something had gone very wrong with banking following the financial crisis. The Vickers Commission also had a clear headline recommendation of structural reform to banking, and further banking scandals with LIBOR and mis-selling of derivatives to small businesses have strengthened the advocates of reform. It seems likely that the Vickers Commission will have a lasting impact on UK banking for many years to come.

Though the Kay Review had a much lower profile, the issues tackled are arguably as important. The way in which equity markets work is important in several ways:

- **Capital allocation.** Is capital allocated properly? Or is it too short-term, or directed to the wrong projects, or missing for viable small- and medium-sized firms?
- **Corporate control.** Are companies given the right incentives and management by capital markets (are executives allowed too much freedom in decision-making, or not enough)?
- **Return on savings and the cost of financial intermediation.** And do savers get the best return from their savings (or is too much of the return taken up by intermediaries throughout the investment chain)?

The work of these two academics, John Kay and John Vickers, might shape the UK economy for decades to come. Or they and their proposals could be quietly returned to the ivory towers, allowing business as usual to continue. In both areas, how this turns out depends on the political process – the interaction of policymakers, regulators, City participants and the media – and there is a long way still to go.

This paper summarises and reviews the Kay Review analysis on the problems of equity markets and proposals for reform, by putting this in the context of the many past debates on this in the light of current economic theory on these issues:

- **Part 1** reviews the history of the economic debate on whether UK financial institutions are responsible for problems in the long-term growth rate of the economy, and gives a brief overview of the context of economic theory on these questions;
- **Part 2** summarises the analysis and proposals in the Kay Review, and outlines the recommendations he makes. This part concludes with preliminary thoughts on how this might play out in the policy making process.

As would be expected, there are still many questions yet to be answered about how this will be taken forward. But one point seems clear: without the political will to make change, it is likely that this will be another Review with great analysis and limited impact, to

add to the long list of similar reviews of UK financial institutions over the past eight decades.

PART 1 – HISTORY AND BACKGROUND OF POLICY DEBATES

Concerns over short-termism in the UK economy are hardly new. In fact, the question of whether the City of London and the structure of UK financial institutions undermined the corporate economy has plagued economic policy making in the UK throughout the twentieth century. A debate which has, arguably, had no consensus or led to structural change.

The main reason for this debate recurring at intervals was the poor performance of the UK economy: as international counterparts seemed to generate better productivity growth, so people looked for reasons why the UK economy was failing. And a frequent answer for why the UK economy performed poorly was to question the structure of finance, and particularly the City of London.

In 1931, a Committee on Finance and Industry (or ‘the MacMillan Committee’) was tasked with looking at why the UK was suffering from economic depression, with such luminaries as John Maynard Keynes as members. Among the Committee’s wide-ranging conclusions was the view that existing finance institutions failed UK businesses as ‘the relations between British banks and industry have never been so close as those between German and American banks and industry.’⁹ The term ‘the MacMillan Gap’ was coined, describing the difficulties facing small- and medium-sized businesses in raising capital and finance.

A proposal of the Committee was to set up the Industrial and Commercial Finance Corporation (ICFC), established in 1945, which provided investment for small and medium-sized businesses in the following decades, and was eventually privatised as 3i in 1994. The aim was to provide the long-term capital which, it seemed, City of London banks were unable to provide.

In the 1950s and 1960s, UK economic productivity growth lagged far behind the US, West Germany, France and Japan, leading to

extensive soul-searching as to why. The influence of the City of London and finance in this economic decline was, however, mostly considered a secondary factor to problems such as the class system and union strife; education; a civil service with insufficient grounding in science; the legacy of empire or wars or poor education and apprenticeship systems.

The 1959 Radcliffe Committee looking at the working of the UK financial system did note the continued difficulties of financing for small businesses (the aforementioned ‘MacMillan Gap’), but this had improved and there were no proposals for institutional reform.¹⁰ Perhaps the relative lack of focus on the investment system reflects the fact that the City of London itself declined significantly in international standing during this period.¹¹ Perhaps also it was because far more national investment was taken forward by state-run industries, with their own particular problems. For a period, therefore, the question of whether UK financial institutions were ruining the UK economy took a backseat to other concerns.

With the emergence of institutional investors – pension funds, insurance companies and asset management companies – in the 1970s and deregulation of the City of London, however, the question of whether the financial sector properly supported the UK economy, and the question of whether private finance markets were inherently too short-termist and failed to support British industry properly returned to centre-stage.¹² The emergence of hostile takeovers and M&A transactions led many people to ask whether shareholders were exercising control over newly empowered executives and bankers. The experience of Lonrho in the 1970s led the chief executive, Tiny Rowland, to be described by Edward Heath, then Prime Minister, as ‘the unpleasant and unacceptable face of capitalism’.

In 1978, a Parliamentary Committee led by former Prime Minister Harold Wilson was tasked with looking at how well these institutional investors were providing funds for industry. This committee took in a wealth of evidence, but its recommendations largely upheld the (recently emerged) status quo, with the only substantive proposal being a loan-guarantee scheme for small

firms.¹³ Better investment would be useful, but it would be ‘wrong to exaggerate the contribution which can be made towards either of these goals by changes in the financial system’.

Despite the sanguine conclusion of the Wilson Committee, in the 1980s there were continued concerns over the potentially negative effects of UK financial markets. This was partly due to deregulated finance, as well as corporate scandals such as the Guinness share-trading scandal, but perhaps a major factor was the slew of corporate takeovers and M&A transactions which developed in the late 1970s and 1980s. Deregulation and the emerging complexity of investment markets led to calls for greater government involvement via regulation.¹⁴ But this also led to calls for institutional investors to act more in the long-term interests of savers.

The investment industry mustered arguments against the charges of short-termism. In 1990, Paul Marsh, a professor at London Business School, was supported by the investment industry to publish a definitive response. In ‘Short-termism on Trial’, he presented evidence that seemingly showed that institutional investors acted in the long-term interests of their clients.¹⁵ If there were problems of short-termism, these were due to misaligned incentives for corporations and corporate executives, not the bad habits of institutional investors. Indeed, John Kay himself wrote a few years later that ‘many myths about short-termism have been effectively debunked’ by Paul Marsh’s work.¹⁶ (Note, however, that Paul Marsh’s pamphlet still accepted that short-termism existed for UK companies, which manifested as under-investment in R&D; but this was given an altogether different diagnosis).

This debate on whether the institutions that constituted the UK’s financial markets inherently caused short-termism and suboptimal outcomes continued. Will Hutton’s *The State We’re In*, published in 1995, captured the mood on the Left by denouncing the UK institutions which, he argued, led to lower investment and short-term outcomes. For Hutton, the institutional structures of the German or Japanese financial system better supported the economy. His book sold millions of copies worldwide, and roused

others to rebut his argument, but ultimately had little effect on policy making.

Under New Labour from 1997, the assumption was that the institutions of the City of London were an important part of export earnings for the UK (certainly true), and also that the City institutions best supported the UK economy (not so clearly true). Given this, the aim should be for light-touch regulation with no interference in market structure. There were many reviews of corporate governance and the City from the 1990s, of which the Myners Review on institutional investors was the most prominent on the topic of investment.¹⁷ However, the recommendations of these Reviews dealt primarily with the regulation of behaviour and did not suggest fundamental changes in market structure.

So, there has been an ongoing debate over the past 80 years on whether UK financial institutions adequately support economic growth. The prevailing view since deregulation in the 1980s has been that regulators should focus on ensuring proper behaviour of investment managers, advisers and executives, but issues of market institutions and structures should be left to competitive forces.

The academic economics problem: it's difficult to prove

Why is there this unresolved debate throughout the twentieth century on the UK economy and the nature of our investment system? One problem is that academic economics really doesn't shine much light on the problem.

Identifying why one large economy grows faster than another over a relatively short period of time is difficult. Data is hard to come by, interactions are complex, and econometric techniques can only do so much (and, often, that is 'not much at all'). International comparisons make data collection harder, yet without them, it is hard to judge whether the experience of one economy is unusual, successful or problematic. An individual company's accounts give only limited insight, and judging several companies side-by-side is

more useful. But the data challenge and complexity of economies makes cross-country comparisons challenging.¹⁸

So, on the long-discussed question of whether Britain's investment system leads to problems for the UK economy, there are some difficult challenges. It is hard to isolate the impact of investment institutions on the overall performance of the economy. And it is hard to tell what the 'right' investment time period really is.

Some economists have, however, taken on the challenge of trying to prove that the UK system under-invests, or is subject to too short-term an approach:

- Mervyn King, now Bank of England Governor, when a young researcher published a paper suggesting that corporations may be using a surprisingly high internal discount rate for investment decisions.¹⁹
- David Miles, currently an external member of the Bank of England Monetary Policy Committee, in 1993 found evidence that investors used too high a discount rate for company cash flows, i.e. investors took too short-term a view.²⁰
- Most recently, Andy Haldane and Richard Davies of the Bank of England tested short-termism among investors in the UK economic sectors, finding evidence in UK equity prices from 1985-2004 of a short-term approach to investment across all sectors, an effect which was particularly pronounced in health and materials.²¹

But, these few examples aside, tackling the question of whether the investment system produces poor outcomes for the UK economy has mostly been left to journalists or market commentators, rather than academic theorists.²² And it is little surprise that there has been no resolution on the question.

Why another Review? Why now?

Government-led reviews of financial markets tend to follow economic crises, high-profile corporate failures or major frauds. Corporate and financial processes are complex, and little understood outside the business world. When the economy seems to be working well, there is little incentive for the media and politicians to question how markets and corporations work. Yet when something goes wrong, government reviews are often the way chosen to delve into the workings of the market, find out – quickly, within the time horizons of the average politician – what went wrong, and what needs to happen to fix this, or at least, make some sort of change to placate critics.²³

The economic crisis has led to many attacks on the current system of capitalism, from left- and right-wingers (just take a look at the wide-ranging ‘Capitalism in Crisis’ series of essays in early 2012 in *The Financial Times*). Many regulatory bodies have taken up the challenge of reforming corporations and financial markets. The European Commission has published several papers on corporate governance in listed companies, the BIS department has undertaken many other reviews, such as that of listed company narrative reporting, and the Takeover Panel and the Financial Reporting Council have all made, or are developing proposals to respond to the crisis. The Kay Review fits clearly in this vein of crisis-induced introspection.

The specific spur for the Review, however, came from the Business Secretary, Vince Cable, who in a speech to the Liberal Democrat party conference in September 2010 attacked ‘corporate short-termism’ which came about in markets which are ‘often irrational or rigged’.²⁴ Aides briefed that Enron and the Kraft-Cadbury takeover were the sort of short-termist actions considered to undermine the UK economy. Following this speech, the department launched consultations on executive pay and on how to improve the long-term focus on UK corporations. Following responses to these consultations came another Review, with more consultation, led by a heavy-hitting commentator and academic with business experience: step forward John Kay.

It is worth noting the provenance of this Review in terms of party and departmental politics. The Review on short-termism was launched by a Liberal Democrat in a Conservative-led coalition. In departmental terms, it did not appear to have strong involvement of HM Treasury. Given this, the Review started with a disadvantage.

Though, with John Kay, one of the UK's foremost academic economists and business commentators – well-versed also in skewering through his Financial Times columns some of the false notions held by market participants and policy makers – at least the Review had strong intellectual leadership to take on the myths and cherished beliefs on current market practice.

PART 2: SUMMARY OF THE REVIEW

What does the Review say?

As with any government review, there are two main parts:

- First, analysis of the problem or problems identified, drawing on academic evidence, interviews and responses to the consultation;
- Second, proposals for change, or at the least an outline of further work required, who needs to do this and, ideally, a roadmap for the government and civil service to take forward.

The emphasis put on each aspect varies by the review, and depends on how clear the problem is, how much political pressure there is for action, the complexity of the problem, and so on. With the Kay Review, as might be expected from a top academic who is also a Financial Times columnist, the analysis is original, insightful and challenges existing beliefs on financial markets, drawing on over 200 written sources, many of which are from academic economics.

The topic of the Kay Review is a complex subject, with the interplay of economics, the law, institutions and behaviour. Unsurprisingly, given that, much of the analysis can be hard to follow. Some of the key points of the analysis are outlined in the following sections.

The analysis

a) Proving short-termism and the problems caused by short-termism

Critics have for decades complained that the ‘short-termism’ of UK financial institutions leads to problems for the UK economy. But the defenders of UK financial institutions have some strong challenges to this claim. There is no useful definition of short-termism (how can you know what the ‘right’ long-term investment is?), and it is

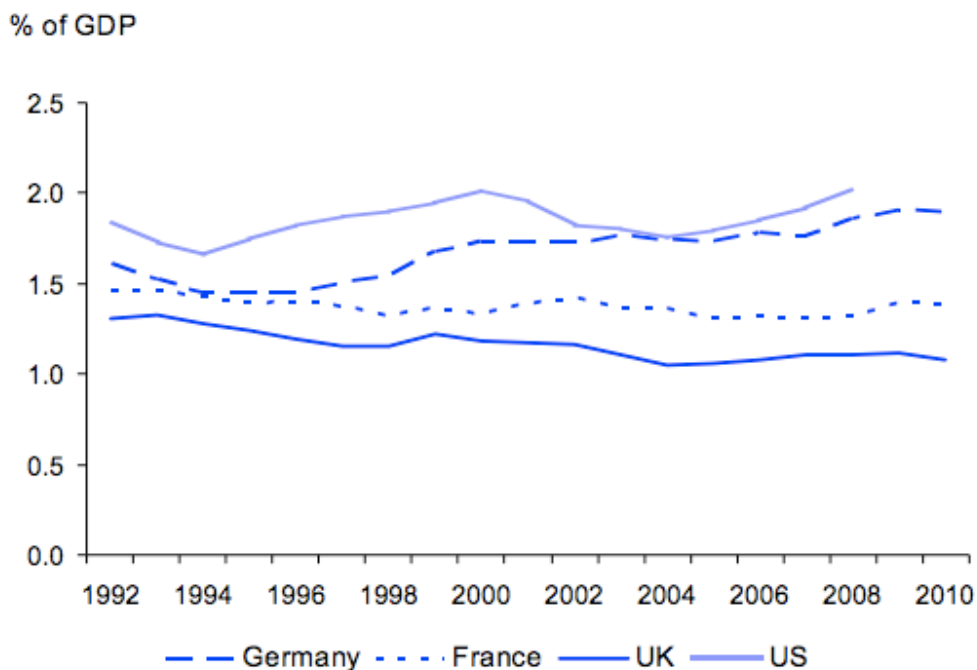
very hard to prove definitively that the current system is problematic. So, goes the defence, the best option is to leave markets be.

An accomplishment of the Kay Review is to outline the intellectual and analytical case for thinking that current financial markets do suffer from short-termism, and that this causes suboptimal economic outcomes:

- Declining business investment as a percentage of GDP and a lower spend on R&D investment in the UK than other major countries (see Figure 1). This is true even though the majority of large companies in the UK have excess cash, but – surprisingly – are choosing not to use this for investment.
- Evidence that corporate executives have incentives towards ‘hyperactivity’, as demonstrated by significantly increased M&A spend by UK companies. The Review notes that ‘from time to time, the frenzy of the trading floor has been matched by the frenzy of the boardroom’.
- The ‘financialisation’ of corporate decision-making, with corporate executives giving greater focus on the current share price than is warranted, rather than strategic operational concerns. The Review gives the examples of ICI and GEC, the two largest industrial companies in the UK in the 1960s, where poor decision-making – driven by a short-term financial focus – undermined the long-term health of the company. According to the Review, however, ‘both companies reacted to weaknesses in their operating activities by trading in businesses rather than by trading in chemicals or electrical goods’. This mind-set, brought on by the influence of financial institutions, also led to problems in such respected UK companies as Marks & Spencer.
- The cultural shift in investment banking, particularly associated with the dominance of US investment banks, from a relationship model to a style favouring transactions and trading.

- The destructive elements of the current process for reporting and giving earnings guidance. The danger is that the UK is moving more towards a system akin to that in the US, where, for example, a recent survey showed that 78 per cent of respondent companies would be willing to reduce discretionary spending on research and development, advertising and hiring in order to meet earnings benchmarks.²⁵

Figure 1: R&D Investment as a percentage of GDP²⁶

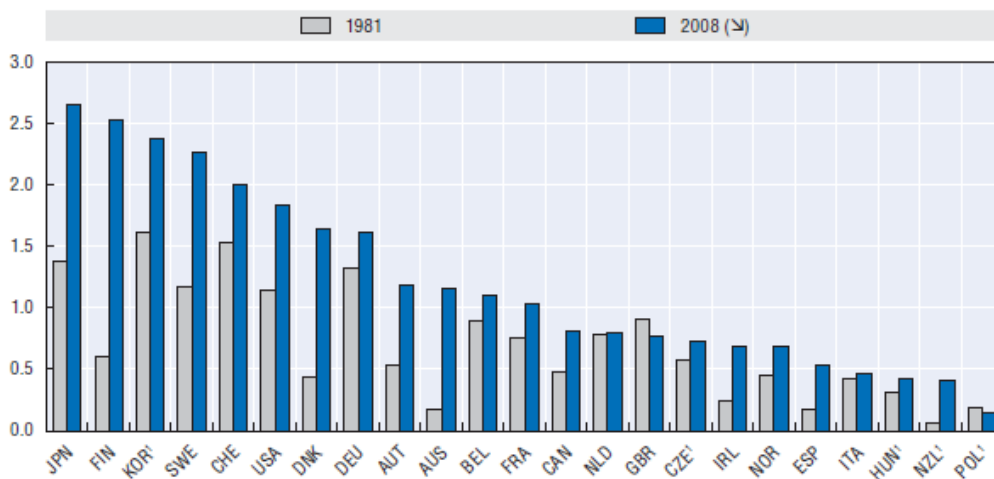


Source: The Kay Review; Eurostat

The problems of UK R&D and innovation are in part due to significantly lower public investment in R&D. But looking at business investment only over a thirty-year period, the UK problem seems even worse. Only the UK and Poland saw a drop in R&D expenditure by the business sector from 1981 to 2008 (see Figure 2). By comparison, many countries such as Finland, Sweden or Australia have seen business R&D double or triple.

There are many potential reasons for the apparent decline in UK business sector R&D, and this may not be all that it seems. The statistics may be underestimating R&D expenditure by UK firms overseas. The traditional measures of R&D developed in the 1970s may not fully capture incremental innovation in service industries such as in the UK. The level of R&D depends on the type of business mix in the economy, and the UK specialises in low-R&D industries (but that, of course, may well be a problem for the long-term growth rate). But even with these caveats, it still is striking the extent to which UK business R&D has declined over the past few decades.

Figure 2: Business expenditure on R&D as a percentage of GDP 1981-2008²⁷



Source: OECD Factbook 2011-2012, Economic, Environmental and Social Statistics

b) Shareholder engagement

Many of the respondents to the Kay Review argued that outcomes would be improved with more shareholder engagement. As the Review points out, however, shareholder engagement is not necessarily good, it depends on the quality and type of engagement. Companies such as Northern Rock were encouraged to take on more risk by shareholders.

At a conceptual level, however, someone who is unhappy with the organisation they are working in, or are invested in, has only a few

choices.²⁸ They can leave the organisation (“exit”), challenge the existing leadership (“voice”) or stay loyal and hope that things change. The Review notes that in terms of UK equity markets, the structure and regulation “overwhelmingly” emphasise exit over voice and this has often led to shareholder engagement of superficial character and low quality.

This must be right. But how shareholders are to be encouraged to voice their opinions, rather than simply exiting the investment, is the big challenge.

c) The changing role of equity markets in the economy

An interesting question raised by the Review is this: what are equity markets actually for? Many people assume that the equity markets are there to raise capital, a view influenced by high-profile IPOs by Facebook or Google. But, as the Review notes, Equity markets are mostly no longer a source of capital for new investment by UK companies. Large UK companies finance new investment from internal cash-flows, not by raising new equity. Financing investment comes also from private equity firms. Capital-raising in UK equity markets in recent years has often been to reduce leverage (in the case of banks), by foreign companies with no connection to UK companies (e.g. Rosneft or Glencore), or IPOs to allow early-stage investors to exit.

As the Review notes, however, despite the decline in the significance of primary issuance, public companies pay far more attention to share prices than they used to: “investor relations and the management of market expectations, activities which once barely concerned senior company executives, are now an important part of their job. The financialisation of companies has put these managers under pressure to ‘do the deal’ and ‘make the numbers’, sometimes at the expense of the development of the capabilities and competitive advantages of their operating businesses.

Given that equity markets are not primarily about raising finance, equity markets should be seen more as a means of governing

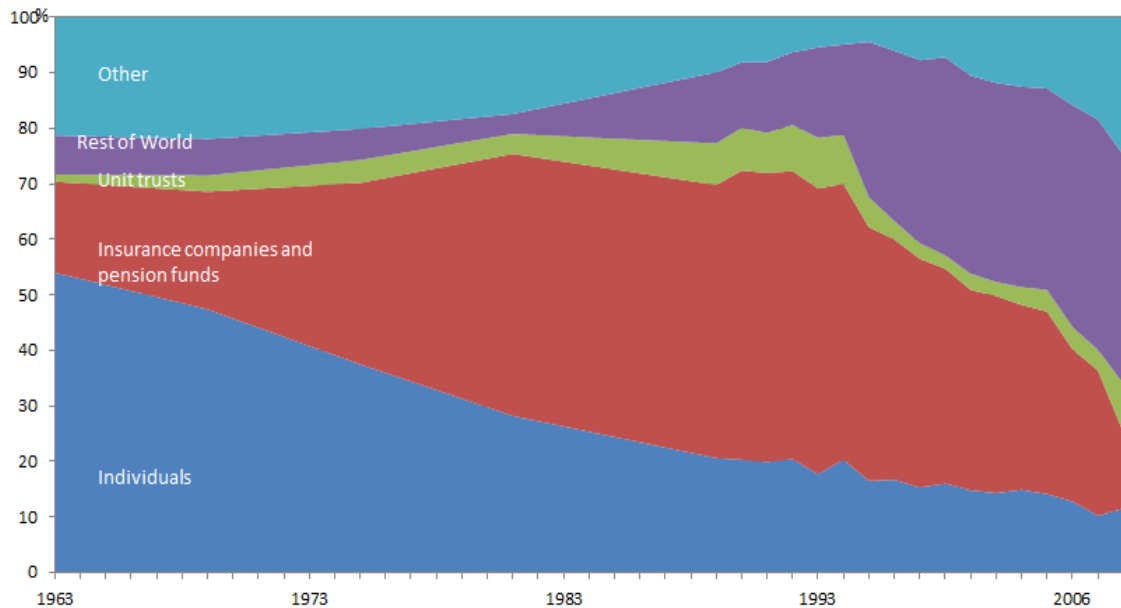
companies, not financing new investment. Equity markets nowadays are more about providing “a means of oversight of the principal mechanism of capital allocation, which takes place in companies. Promoting stewardship and good corporate governance is not an incidental function of equity markets”.²⁹ Rather than a focus on financial measures, the structures should encourage investors to encourage companies to focus on operational advantages.

d) Changing ownership chains

A major change in the nature of investment markets in the past fifty years has been the lengthening chain of ownership. Individual shareholdings have declined significantly. Insurance companies and pension funds have outsourced their functions to specialist managers. Sovereign wealth funds have become major holders of equities globally.

Furthermore, the decline of individual ownership has meant an ever-growing layer of agents between the company and savers: registrars, nominees, custodians, asset managers, fund-of-fund managers, trustees, investment consultants, agents who ‘wrap’ products, retail platforms, distributors and independent financial advisers. Each agent will have compliance staff, auditors and lawyers and earn enough to remunerate the employees and reward its own investors. There is also the tendency nowadays to view the objective of the investment market in terms of the goals of market participants, not end-savers:

Goals such as liquidity, transparency, and price discovery have come to be regarded as ends in themselves, not as intermediate steps towards the underlying objectives of high performing companies and good returns for savers.³⁰

Figure 3: Ownership of UK corporate equities 2010

Source: ONS share ownership data, 2010. 'Other' is a wide category which in the past decade includes hedge funds and securities dealers. ONS data for 2010 is not directly comparable with that of previous years due to a change in methodology. The 'Rest of the World' does not identify holders who have traditionally been UK based but taken over by foreign competitors, yet remain based in the UK. For example, Blackrock's takeover of BGI would reclassify this asset manager as a foreign owner.

The rise of agents in the investment chain is in part caused by regulation. But the Review puts the underlying reason down to the loss of 'trust and confidence' throughout the investment chain. Understanding why trust is lost is complex, but perhaps the best way to think of it is that as the number of agents increase, trust decreases, as each agent needs to cover themselves against legal risk. Pension trustees, for example, have a range of onerous legal responsibilities: the best way to limit legal risk is to outsource the responsibility to an 'expert'.

This suggests that one remedy is to shorten the investment chain, with stronger investing entities taking on the functions of all the intermediaries, and limiting the loss of trust throughout the chain.

e) Markets are not always ('strong-form') efficient

The dominant strand of thinking in financial theory over the past fifty years has been the development of the efficient-market hypothesis. In its simplest form, this hypothesis means that all publicly available information is incorporated in prices. This was derived from analysis in the 1960s that it was hard to prove whether any fund managers had a superior ability to pick stocks on a risk-adjusted basis.³¹ Since the 1960s, many finance theorists have shown that it is hard for fund managers to achieve above-market returns on a risk-adjusted basis over a long period of time, because publicly available information is quickly incorporated into prices.

But the efficient-market hypothesis is sometimes taken further, to mean that all market participants are acting in the best interests of the end saver, and that the share price is always a reflection of the fundamental value. If this was always true, there would never be a problem in investment management. Indeed, as the Review notes, many market participants do believe this to be the case:

Some practitioners to whom we talked displayed an almost mystical faith in market efficiency, expressed in simple maxims such as ‘you can’t buck the market’, and ‘the market knows best’.

The Kay Review outlines a more nuanced, and therefore more useful, view of market efficiency. Share prices clearly do reflect market expectations of long-term performance. For a company with a price earnings ratio of 15, for example, around two-thirds of the current fundamental value of the company would be derived from earnings that would arise more than five years ahead. But there are imperfections which mean market prices are not necessarily or always the same as the fundamental value:

- Information about future company performance is speculative and imperfectly transmitted by agents –price discovery can never be perfect;
- There is misalignment of incentives throughout the chain. An asset manager will follow the incentives from the reward system placed on them by pension funds or individual savers, but these incentives can differ from the long-term objective of better returns for savers or better companies. There is a clear bias for

many agents, for example, towards doing more transactions rather than fewer, leading to over-trading or unnecessary M&A transactions; and

- Individuals have cognitive biases in investing, such as overconfidence in picking stocks. These biases can be exploited by agents and may actually be exacerbated, not solved, by providing more information to savers.

Why does the Review spend a whole chapter on the (false) claims for strong market efficiency? Ultimately, because without explaining that ‘the market’ is not always right, it is hard to make the case for change. The evidence is, however, clear that markets are not always correct, due to organisational and cognitive imperfections.

f) The problems of judging asset managers by a short-term benchmark

The Review puts a major focus on the roles of asset managers – who make buy and sell decisions – and asset holders, agents such as pension fund trustees and insurance companies which have responsibility for asset management as agents for savers (who enjoy the economic interest).

Asset managers are almost always judged in relative terms, against a benchmark or other funds. The length of time over which an asset manager is judged is important to the way in which they invest. Evidence suggests that there is little or no serial correlation in asset manager performance: ‘past performance is not necessarily a guide to future performance: it is, in fact, virtually no guide to future performance.’ If savers rely on short-term performance information, it will have huge uncertainty and potentially no useful value. But many asset managers are judged on a short-term basis, with performance being discussed each quarter.

So, although the concern of savers is *long-term absolute* performance, the concerns of all agents is *short-term relative* performance. This has several negative implications:

- Asset managers stick close to the benchmark ('closet-tracking'), to avoid being caught out on a short-term basis.
- Research on fundamental value of companies can be less useful or valuable than trading or speculating on market expectations. This skews the incentives being given to companies by investors.
- Asset managers have limited incentive to engage with companies. Engagement is seen as a cost, with the benefit shared by all. In a world where asset managers are judged on short-term relative performance, there is little incentive for engagement.

g) Focus on market structure is needed

The current structure of the investment management industry has many suboptimal features. Asset management is a product for which it is very difficult to assess product quality. Furthermore, due to regulation, there are layers upon layers of agents, as each agent tries to minimise their legal and regulatory risk. Competition is therefore focused on marketing and product proliferation, not on price. The market structure is not set up to allow competition on fees, and there is clustering in charging levels – among asset managers, as well as higher up with private equity and hedge funds.

In line with his article with John Vickers of two decades previously, and in line with the findings of the Vickers Commission on Banking, John Kay notes that ultimately structural change is needed to change this negative behaviour:

We believe this structural focus is the right approach. If the market structure is such as to give the right incentive, then appropriate behaviour should follow, and regulatory oversight of such behaviour can be reduced: if market structure and incentives are not right, then regulation which imposes behaviour which conflicts with the commercial interests of participants is likely to enjoy limited success.³²

But how will this structural change come about? Is the focus primarily on asset management companies correct? If the problems are caused by the way in which pension funds and retail savers invest in asset managers (for example, through a short-term relative benchmark), is structural change to those markets required? Arguably, many questions raised by the Kay Review's analysis are not answered directly by the recommended policy actions.

The recommendations

The analysis in the Kay Review explores some dense, complex topics, and makes some points which directly challenge existing market beliefs and practice. It can seem surprising, therefore, that the recommendations seem to be relatively light-touch. There is, at the least, seemingly no major structural change recommended.

Culture and behaviour

The main recommendations relate to trying to instil better culture and behaviour in asset managers, company directors and agents:

- **An expanded Stewardship code.** The expansion of the Stewardship Code, to broaden the definition of stewardship and focus on strategic issues, not just corporate governance. The hope is that this will build a culture of trust and respect.
- **Good Practice Statements.** Company directors, asset managers and asset holders should adopt Good Practice Statements that promote stewardship and long-term decision making, rather than a purely financial focus. For asset managers, the Good Practice Statement should include guidance towards more concentrated portfolios, less requirement for liquidity, less emphasis on short-term relative performance and closer engagement between asset managers and companies.
- **An investors' forum.** This should be established to facilitate collective engagement by investors in UK companies. The Review also argues that companies should consult their major

long-term investors over major board appointments, a process which presumably could potentially be managed through such an investor forum. Passive investors should also take their stewardship responsibilities seriously.

Company reporting

The recommendations also looked to encourage companies to break out of the mode of responding to short-term market demands. The most obvious recommendations are that mandatory quarterly reporting obligations should be removed, and more generally that companies should look to disengage from the process of managing short-term earnings and give high quality, succinct narrative-reporting.

Fiduciary standards

Fiduciary standards should apply to all relationships in the investment chain, and the Law Commission should review the legal concept of fiduciary duty to address uncertainties and misunderstandings on behalf of trustees and advisers. In particular, pension trustees should be comfortable taking a wider view.

Remuneration

Both directors' remuneration and that of asset managers should be structured to relate to sustainable long-term business performance, while incentives should be provided only in the form of company shares to be held at least until after the executive has retired from the business, or the manager no longer runs the fund.

Disclosure of all costs

Current disclosure underestimates the costs. Trading costs, for example, are often not disclosed. The Review recommends that asset managers should disclose all costs, including estimated transaction costs, and performance fees. Furthermore, all income from stock-lending should be disclosed and rebated to investors.

Other recommendations

There are also a set of other seemingly more minor recommendations, such as cost effective means for individual investors to hold shares directly on an electronic register, or a specific Government review of metrics and models employed in the investment chain to highlight their uses and limitations.

There were some areas that the Review did not touch on in the final report, despite media speculation that recommendations in these areas could be included. No changes to the existing takeover rules were proposed, instead, all that was proposed was that ‘the scale and effectiveness of merger activity of and by UK companies should be kept under careful review by BIS and by companies themselves’.

There was no discussion of the structure of pension funds, or (unnecessary) proliferation of investment funds, even though this contributes to dispersion of investments which the Review argues is a problem for shareholder engagement.

Reaction

The media and market reaction to the Kay Review has been relatively muted. This is perhaps because the Review was published in the middle of summer, after the start of Parliamentary Recess. It may also be because the analysis itself dealt with broad conceptual issues, rather than specific structural measures. A key problem is how the recommendations will be taken forward.

The industry gave a mixed response. Of those investors most likely to support long-term engaged investing, several noted that important aspects were left hanging in the report, for example, on fiduciary duties or engagement, and they were not sure how this would work out in practice.³³ Although there were few direct attacks on the analysis, John Authers at the *Financial Times* noted that that ‘sensible proposals’ on banning quarterly reporting and making fund managers have a stake in their own funds had ‘proved unsurprisingly unpopular’.³⁴ Presumably, however, opponents of

the ideas are keeping below the radar, saving their efforts to attack future, more detailed proposals.

Existing market beliefs and shibboleths, for example on efficiency or liquidity, are powerful and hard to overcome – they suit the interests of many market participants. The reaction of the *Financial Times* Lex column to the Kay Review gives a flavour of the difficulty.³⁵ Lex came out with a standard defence of current practice and beliefs: John Kay’s vision was ‘old-fashioned’ and ‘flawed’; selling a share is better than shareholder engagement (even though the Kay Review presented compelling arguments for why engagement might, in some cases, be better); and ending quarterly reporting was bad as it would prevent investors from making informed decisions (even though the Review gave good arguments that there was too much disclosure, and additional information undermines long-term objectives). The so-called ‘shareholder spring’ was evidence enough of investors taking long-term responsibility (even though in fact the number of votes against executive pay is not unusually high, and was higher in 2002-3).³⁶

Of course, as a *Financial Times* columnist, John Kay could simply argue this out with the Lex columnists directly. But changing the mindset of market participants and regulators more widely is difficult, and will require sustained reform from government, regulatory authorities and market bodies.

The barriers to change

Will these changes make enough of a difference? Perhaps, but there are at least five causes for concern.

First, the recommendations are aimed at a range of parties, in particular the asset management industry, and no one body or group is responsible for driving through change. The development of Good Practice codes and an investor forum will most likely need significant input from the asset management industry itself and – potentially – will open up avenues for the proposals to be neutered or buried. Although many asset managers appeared to respond

positively in the consultation, they may, when it comes to the details and any cost implication, revert to acting as competitors, rather than collaborators on a better market structure.

Second, how will the central recommendation of Good Practice codes – with more concentrated portfolios and lower diversification – work without enforcement? Ultimately, there have been many codes in the past twenty years on financial markets (although not particularly for investment managers, as the Stewardship Code dates only to 2010). Will enforcement come simply by shaming managers? Fiduciary duties may set a minimum level of behaviour for agents and asset managers, but an industry code will need to be enough of an incentive for asset managers to behave differently. If asset managers do not change, it seems unlikely that the changes in culture demanded of corporate executives will also happen.

A third concern is that while the Review emphasises the role of asset managers, there is little discussion of pension trustees and retail investors. A powerful defence of the asset management industry against the charge that they fail to act in the long-term interests of savers is that they follow the needs of the client. The Myners Review in 2001 argued that a significant part of the problem was that ‘at the heart of the system, we often make wholly unrealistic demands of pension fund trustees... yet many lack either the resources or the expertise’.³⁷ It is not clear that the Kay Review recommendations will do enough to overcome the weakness of end investors and the natural bias of agents in the chain towards giving poor investment advice.

Another concern is that existing market beliefs are so firmly engrained. As the example of the reaction of the *Financial Times* Lex column shows, there will always be people who defend existing beliefs, and change will take a long time. Who will champion these ideas? Without strong leadership from a well-respected institution with intellectual leadership (the Bank of England? HM Treasury?) existing market beliefs may well prove too strong.

Hence, the final concern is that this debate will become mired in party political and inter-departmental wrangling. The Kay Review

was located in the Business Innovation and Skills (BIS) department, under Vince Cable, yet HM Treasury retains oversight of financial regulation. The Treasury traditionally has taken the view that market structures are best left to market participants. The Chancellor, George Osborne, a Conservative, may be happy to see Vince Cable, a Liberal Democrat, pursue these measures, but then not give the support required from the Treasury for reforms to succeed. And, anyway, the political focus is on short-term deficit reduction and immediate growth measures, not the long-term health of the economy.

An agenda for taking this forward

There are some areas, however, which the government and City participants could consider further. Some suggestions are:

1) Private equity ownership models?

John Kay notes that the best form of long-term investing, which gives better long-term outcomes for corporations and investors, is concentrated ownership with engagement from managers. The economic literature suggests several models of company ownership which do this better than the public company: long-term family ownership; financiers on boards in the past; private equity ownership; and, of course, the example of Warren Buffett's strategy.³⁸

Private equity ownership in particular has been seen by many academics in past decades as a way to improve the running of large companies.³⁹ There are clear principal-agent problems with the model and problems of high fees and too much leverage, and the average returns to pension funds, net of fees, have been poor.⁴⁰ But the evidence is that the best private equity funds do achieve better company operating performance.⁴¹ Are there ways to bring the benefits of concentrated private ownership to public institutional investors?

2) Changes to voting rights?

Should proposals for additional voting rights for long-term investors be promoted more strongly? The Review rejected these in favour of an approach of trying to inculcate stewardship in investors. After all, UK companies are legally free to create differential share classes with different voting rights if they would like. But the UK is unusual in having a very strong presumption against dual-class shares in companies.⁴² Perhaps a greater diversity of corporate legal structures would allow UK corporations that require a long-term approach to have greater success.

3) How to address over-trading and closet tracking?

What more needs to be done to address over-trading and closet tracking by investment managers? Disclosure of trading costs will help. But some further suggestions are that investment managers should be required to publish their ‘active share’ statistics, measuring the amount of the portfolio which simply tracks the index.⁴³ Better statistics could be publicised by regulators on the benefits and costs of active fund management versus tracking products.

4) How will a new definition of fiduciary duty be developed?

There seems to be a fair degree of agreement that one problem is the definition of fiduciary duty for investors and trustees, or the interpretation of that duty. How will this be changed? Who will champion this change? The Review is, understandably, light on details here. It will be important, however, for this to be taken forward with a view on ensuring that perceptions of fiduciary duty change, not just the legal wording itself.

CONCLUSION

Will Hutton, reflecting 10 years later on how his thesis in *The State We're In* had held up, noted that:

Modern capitalism is an ever-moving target: trying to understand it, and then making a compelling case for reform, is bloody difficult.⁴⁴

The Kay Review does this well. Today's model of UK financial institutions grew up in response to deregulation of the structure of financial markets in the 1980s, and regulation of conduct since then. The Review offers powerful explanations for the problems that this approach has created. The case for reform is equally powerful.

Whether the suggested reforms will succeed, however, depends on having firm recommendations, championed by government, media commentators and end investors, not just taken forward by market participants themselves. How this will work – and whether it will work – remains to be seen.

ANNEX: ALL KAY REVIEW RECOMMENDATIONS

- 1) The Stewardship Code should be developed to incorporate a more expansive form of stewardship, focussing on strategic issues as well as questions of corporate governance.
- 2) Company directors, asset managers and asset holders should adopt Good Practice Statements that promote stewardship and long-term decision-making. Regulators and industry groups should takes steps to align existing standards, guidance and codes of practice with the Review's Good Practice Statements.
- 3) An investors' forum should be established to facilitate collective engagement by investors in UK companies.
- 4) The scale and effectiveness of merger activity of and by UK companies should be kept under careful review by BIS and by companies themselves.
- 5) Companies should consult their major long-term investors over major board appointments.
- 6) Companies should seek to disengage from the process of managing short-term earnings expectations and announcements.
- 7) Regulatory authorities at EU and domestic level should apply fiduciary standards to all relationships in the investment chain which involve discretion over the investments of others, or advice on investment decisions. These obligations should be independent of the classification of the client, and should not be capable of being contractually overridden.
- 8) Asset managers should make full disclosure of all costs, including actual or estimated transaction costs, and performance fees charged to the fund.

- 9) The Law Commission should be asked to review the legal concept of fiduciary duty as applied to investment to address uncertainties and misunderstandings on the part of trustees and their advisers.
- 10) All income from stock lending should be disclosed and rebated to investors.
- 11) Mandatory IMS (quarterly reporting) obligations should be removed.
- 12) High quality, succinct narrative reporting should be strongly encouraged.
- 13) The Government and relevant regulators should commission an independent review of metrics and models employed in the investment chain to highlight their uses and limitations.
- 14) Regulators should avoid the implicit or explicit prescription of a specific model in valuation or risk assessment and instead encourage the exercise of informed judgment.
- 15) Companies should structure directors' remuneration to relate incentives to sustainable long-term business performance. Long-term performance incentives should be provided only in the form of company shares to be held at least until after the executive has retired from the business.
- 16) Asset management firms should similarly structure managers' remuneration so as to align the interests of asset managers with the interests and timescales of their clients. Pay should therefore not be related to short-term performance of the investment fund or asset management firm. Rather a long-term performance incentive should be provided in the form of an interest in the fund (either directly or via the firm) to be held at least until the manager is no longer responsible for that fund.
- 17) The Government should explore the most cost effective means for individual investors to hold shares directly on an electronic register.

Demos – Licence to Publish

The work (as defined below) is provided under the terms of this licence ('licence'). The work is protected by copyright and/or other applicable law. Any use of the work other than as authorized under this licence is prohibited. By exercising any rights to the work provided here, you accept and agree to be bound by the terms of this licence. Demos grants you the rights contained here in consideration of your acceptance of such terms and conditions.

1 Definitions

- a 'Collective Work' means a work, such as a periodical issue, anthology or encyclopedia, in which the Work in its entirety in unmodified form, along with a number of other contributions, constituting separate and independent works in themselves, are assembled into a collective whole. A work that constitutes a Collective Work will not be considered a Derivative Work (as defined below) for the purposes of this Licence.
- b 'Derivative Work' means a work based upon the Work or upon the Work and other pre-existing works, such as a musical arrangement, dramatization, fictionalization, motion picture version, sound recording, art reproduction, abridgment, condensation, or any other form in which the Work may be recast, transformed, or adapted, except that a work that constitutes a Collective Work or a translation from English into another language will not be considered a Derivative Work for the purpose of this Licence.
- c 'Licensor' means the individual or entity that offers the Work under the terms of this Licence.
- d 'Original Author' means the individual or entity who created the Work.
- e 'Work' means the copyrightable work of authorship offered under the terms of this Licence.
- f 'You' means an individual or entity exercising rights under this Licence who has not previously violated the terms of this Licence with respect to the Work, or who has received express permission from Demos to exercise rights under this Licence despite a previous violation.

2 Fair Use Rights

Nothing in this licence is intended to reduce, limit, or restrict any rights arising from fair use, first sale or other limitations on the exclusive rights of the copyright owner under copyright law or other applicable laws.

3 Licence Grant

Subject to the terms and conditions of this Licence, Licensor hereby grants You a worldwide, royalty-free, non-exclusive, perpetual (for the duration of the applicable copyright) licence to exercise the rights in the Work as stated below:

- a to reproduce the Work, to incorporate the Work into one or more Collective Works, and to reproduce the Work as incorporated in the Collective Works;
- b to distribute copies or phonorecords of, display publicly, perform publicly, and perform publicly by means of a digital audio transmission the Work including as incorporated in Collective Works; The above rights may be exercised in all media and formats whether now known or hereafter devised. The above rights include the right to make such modifications as are technically necessary to exercise the rights in other media and formats. All rights not expressly granted by Licensor are hereby reserved.

4 Restrictions

The licence granted in Section 3 above is expressly made subject to and limited by the following restrictions:

- a You may distribute, publicly display, publicly perform, or publicly digitally perform the Work only under the terms of this Licence, and You must include a copy of, or the Uniform Resource Identifier for, this Licence with every copy or phonorecord of the Work You distribute, publicly display, publicly perform, or publicly digitally perform. You may not offer or impose any terms on the Work that alter or restrict the terms of this Licence or the recipients' exercise of the rights granted hereunder. You may not sublicense the Work. You must keep intact all notices that refer to this Licence and to the disclaimer of warranties. You may not distribute, publicly display, publicly perform, or publicly digitally perform the Work with any technological measures that control access or use of the Work in a manner inconsistent with the terms of this Licence Agreement. The above applies to the Work as incorporated in a Collective Work, but this does not require the Collective Work apart from the Work itself to be made subject to the terms of this Licence. If You create a Collective Work, upon notice from any Licensor You must, to the extent practicable, remove from the Collective Work any reference to such Licensor or the Original Author, as requested.
- b You may not exercise any of the rights granted to You in Section 3 above in any manner that is primarily intended for or directed toward commercial advantage or private monetary compensation. The exchange of the Work for other copyrighted works by means of digital filesharing or otherwise shall not be considered to be intended for or directed toward commercial advantage or private monetary compensation, provided there is no payment of any monetary compensation in connection with the exchange of copyrighted works.

C If you distribute, publicly display, publicly perform, or publicly digitally perform the Work or any Collective Works, You must keep intact all copyright notices for the Work and give the Original Author credit reasonable to the medium or means You are utilizing by conveying the name (or pseudonym if applicable) of the Original Author if supplied; the title of the Work if supplied. Such credit may be implemented in any reasonable manner; provided, however, that in the case of a Collective Work, at a minimum such credit will appear where any other comparable authorship credit appears and in a manner at least as prominent as such other comparable authorship credit.

5 Representations, Warranties and Disclaimer

A By offering the Work for public release under this Licence, Licensor represents and warrants that, to the best of Licensor's knowledge after reasonable inquiry:

- i Licensor has secured all rights in the Work necessary to grant the licence rights hereunder and to permit the lawful exercise of the rights granted hereunder without You having any obligation to pay any royalties, compulsory licence fees, residuals or any other payments;
- ii The Work does not infringe the copyright, trademark, publicity rights, common law rights or any other right of any third party or constitute defamation, invasion of privacy or other tortious injury to any third party.

B except as expressly stated in this licence or otherwise agreed in writing or required by applicable law, the work is licenced on an 'as is' basis, without warranties of any kind, either express or implied including, without limitation, any warranties regarding the contents or accuracy of the work.

6 Limitation on Liability

Except to the extent required by applicable law, and except for damages arising from liability to a third party resulting from breach of the warranties in section 5, in no event will licensor be liable to you on any legal theory for any special, incidental, consequential, punitive or exemplary damages arising out of this licence or the use of the work, even if licensor has been advised of the possibility of such damages.

7 Termination

A This Licence and the rights granted hereunder will terminate automatically upon any breach by You of the terms of this Licence. Individuals or entities who have received Collective Works from You under this Licence, however, will not have their licences terminated provided such individuals or entities remain in full compliance with those licences. Sections 1, 2, 5, 6, 7, and 8 will survive any termination of this Licence.

B Subject to the above terms and conditions, the licence granted here is perpetual (for the duration of the applicable copyright in the Work). Notwithstanding the above, Licensor reserves the right to release the Work under different licence terms or to stop distributing the Work at any time; provided, however that any such election will not serve to withdraw this Licence (or any other licence that has been, or is required to be, granted under the terms of this Licence), and this Licence will continue in full force and effect unless terminated as stated above.

8 Miscellaneous

A Each time You distribute or publicly digitally perform the Work or a Collective Work, Demos offers to the recipient a licence to the Work on the same terms and conditions as the licence granted to You under this Licence.

B If any provision of this Licence is invalid or unenforceable under applicable law, it shall not affect the validity or enforceability of the remainder of the terms of this Licence, and without further action by the parties to this agreement, such provision shall be reformed to the minimum extent necessary to make such provision valid and enforceable.

C No term or provision of this Licence shall be deemed waived and no breach consented to unless such waiver or consent shall be in writing and signed by the party to be charged with such waiver or consent.

D This Licence constitutes the entire agreement between the parties with respect to the Work licensed here. There are no understandings, agreements or representations with respect to the Work not specified here. Licensor shall not be bound by any additional provisions that may appear in any communication from You. This Licence may not be modified without the mutual written agreement of Demos and You.

NOTES

¹ At the launch of the Review, John Kay noted that the Review publication was ‘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.’ This Demos Finance paper aims to give a less dense summary for the reader looking for the main concepts in almost as readable a form.

² The Committee’s recommendations were strongly influenced by John Maynard Keynes, a committee member, and led to the creation in 1945 of the Industrial and Commercial Finance Corporation to provide long-term finance to small and medium-sized businesses. At the same time, the Finance Corporation for Industry (FCI) was mandated to fund large companies. The two bodies merged in 1973, becoming Finance for Industry (FFI). In turn, this became Investors in Industry in 1983, and subsequently was privatised as 3i in 1994.

³ Lex column, ‘Blurred Vision’, *The Financial Times*, 23 July 2012.

⁴ A recent paper on a sample of 395 deals between 1991 and 2007 in Western Europe by large, mature private equity firms found that about one third of the returns was due to better performance by the owned companies, with a positive impact on operating performance relative to publicly-quoted peers. Acharya et al., ‘Corporate Governance and Value Creation: Evidence from Private Equity’, Working paper, 2012.

⁵ This point was raised by Andy Haldane of the Bank of England in *Prospect Magazine*, ‘The Dangers of Haste’, August 2012.

⁶ *Hansard*, Budget Resolutions and Economic Situation, Debate 22 March 1993 vol 221, cc 630-714.

⁷ ‘Regulatory Reform in Britain’ John Kay and John Vickers, *Economic Policy*, Vol. 3, No. 7 (Oct., 1988), pp. 285-351, with discussion comments from Colin Mayer and David Ulph.

⁸ *Ibid*, see discussion comments by Colin Mayer.

⁹ The MacMillan Report, 1931.

¹⁰ Radcliffe Committee (1959), *Committee on the Working of the Monetary System*, Report, Cmnd 827, London: HMSO. The 1971 Bolton Committee on financing of small firms also noted the continued difficulties small firms faced raising finance.

¹¹ Ranald Michie notes that the City’s decline in the 1950s and 1960s mirrored that of the UK. R. Michie, 1992, *The City of London: Continuity and Change 1850-1990*.

¹² See the Demos Finance working paper *Shareholder Springs Eternal*, June 2012 for more background and history on the debates on corporate governance and institutional investors.

¹³ As one academic, Colin Mayer, later caustically observed that the Committee gave ‘the worst example of this approach of observation without analysis. A wealth of statistical and impressionistic evidence without a framework within which to organize the data. The consequence has been an almost impenetrable set of tomes whose impact has fallen well short of their mass’. Colin Mayer, ‘New Issues in Corporate Finance’, *European Economic Review* 32 (1988) 1167-1189.

¹⁴ The 1984 Gower Report on investor protection argued that investor protection needed a stronger legal basis and government enforcement, as well as improved mechanisms for self-regulation. Many of these ideas were incorporated into the 1986 Financial Services Act.

¹⁵ Paul Marsh., ‘Short-termism on Trial’, 1990, Institutional Fund Managers’ Association, London.

¹⁶ John Kay and Aubrey Silverston, ‘Corporate Governance’, 31 August 1996, Perspectives on Company Law Vol 2.

¹⁷ *HM Treasury*, ‘Institutional Investment in the United Kingdom: A Review’, 2001.

¹⁸ This point is also raised in Colin Mayer, ‘New Issues in Corporate Finance’, *European Economic Review* 32 (1988) 1167-1189.

¹⁹ King, M A (1972), ‘Taxation and Investment Incentives in a Vintage Investment Model’, *Journal of Public Economics*, Vol. 1 (1), pp. 121-148. Summarised in Haldane and Davies, 2011.

²⁰ Miles, D (1993), ‘Testing for Short Termism in the UK Stock Market’, *Economic Journal*, Vol. 103 (421), pp. 1379-1396.

²¹ ‘The Short Long’, Andrew Haldane and Richard Davies, Bank of England, May 2011.

²² . From a private-sector perspective, Dominic Barton, the global head of McKinsey, has outlined the problems of short-termism throughout the investment chain, and made a call for institutional and behavioural change. Dominic Barton, ‘Capitalism for the Long-term’, *Harvard Business Review*, March 2011.

²³ Academic political scientists have explored this. See, for example, Pepper Culpepper, *Quiet Politics*, 2012.

²⁴ Reported in *The Guardian*, 22 September 2010.

²⁵ Graham, J, Harvey, C, & Rajgopal, S 2005, 'The Economic Implications of Corporate Financial Reporting', *Journal Of Accounting And Economics*, 40, 1-3, pp. 3-73, EconLit with Full Text, EBSCOhost, viewed 10 July 2012. Quoted in the Kay Review, p. 65.

²⁶ The Kay Review, p. 16.

²⁷ OECD Main Science and Technology Indicators.

²⁸ The 'Exit, Voice and Loyalty' framework was developed by the economist and political scientist, Alfred Hirschman in 1970.

²⁹ Kay Review, p. 28.

³⁰ Kay Review, p.30.

³¹ A major study was by Michael Jensen, who found that for a sample of 115 fund managers over a twenty-year period, it was not possible to say with statistical significance that any managers made risk-adjusted returns over a weighted average market portfolio. Michael Jensen, 'The performance of mutual funds in the period 1945-1964', *Journal of Finance*, 23, no.2, 1967. This paper created the distinction between *alpha*, the element of a fund's return due to the manager's supposed ability, and *beta*, the element of a fund's return due to market movements and the risk of the portfolio.

³² Kay Review, p.44.

³³ See, for example, the criticisms by James Featherby (Chair of the Church of England's Ethical Investment Advisory Group) or Saker Nusseibeh (Hermes Fund Management) reported in the *Financial Times* on 29 July and 2 September respectively.

³⁴ John Authers, 'A return to vision of J.P. Morgan', *The Financial Times*, July 29, 2012.

³⁵ Lex column, 'Blurred Vision', *The Financial Times*, 23 July 2012.

³⁶ See evidence from MANIFEST, PIRC as to the history of shareholder voting

³⁷ *HM Treasury*, 'Institutional Investment in the United Kingdom: A Review', 2001, p.1.

³⁸ For evidence on financiers on boards, see the historical study on J.P. Morgan in the Brad Delong 'Did J.P. Morgan's Men Add Value? A Historical Perspective on Financial Capitalism', NBER Working Paper, 1990. On family ownership, see McConaughy et al, 'Founding family controlled firms: efficiency and value', 1998, *Review of Financial Economics* 7, 1 –19.

³⁹ See, for example, Michael Jensen, 'Eclipse of the Public Corporation', *Harvard Business Review*, 1989.

⁴⁰ See 'Private Equity, Public Loss?', a report written by Peter Morris for the Center for the Study of Financial Innovation; Kaplan and Schoar, 2005, studied internal rates of return (IRRs) net of management fees for 746 funds during 1985-2001 and found that the median fund generated only 80% of the S&P500 return and the mean fund's return was only slightly higher, at around 90%, although the larger, more established funds did achieve mean performance of over 150% of the S&P return. Kaplan, S. and A. Schoar. 'Private Equity Performance: Returns, Persistence, and Capital Flows'. *Journal of Finance*, 2005.

⁴¹ A recent paper on a sample of 395 deals 1991-2007 in Western Europe by large, mature PE firms found that about one-third of the returns was due to better performance by the owned companies, with a positive impact on operating performance relative to publicly-quoted peers. Acharya et al. 'Corporate Governance and Value Creation: Evidence from Private Equity', Working paper, 2012.

⁴² This point was raised by Andy Haldane of the Bank of England in *Prospect Magazine*, 'The Dangers of Haste', September 2012.

⁴³ See, for example, the work by Martijn Cremers at Yale University, including 'How Active is Your Fund Manager? A New Measure that Predicts Performance' (with A. Petajisto), *Review of Financial Studies*, Vol. 22, No. 9, 3329-3365, 2009

⁴⁴ Will Hutton, 'Did I get it wrong?', *The Observer*, January 9, 2005.

INTRODUCING DEMOS FINANCE

Ever since the financial crisis of 2008, there has been a clouded and polarised debate over the role and the future of the financial services in the UK. The public and politicians distrust the sector but know little about it; the financial services industry itself feels unduly victimised. With the world still reeling from the effects of the crisis, politicians, the media and the interested public need a reliable source of objective, measured and easily comprehensible analysis of the financial sector.

Demos Finance has two specific aims: educating these groups on the day-to-day activities of the financial sector, so enabling them to engage in informed debate about the sector; and analysing policy as it relates to the financial services industry whilst identifying how to maximise the sector's benefits to the UK economy. Based as a discrete research unit within the established and well-regarded think tank Demos, Demos Finance will produce original research reports, expert commentary, insight and analysis on the most pressing financial issues of the day. It will generate new ideas and public policy solutions but it will also help to explain and 'translate' complex arguments to a non-specialist public in plain, jargon-free prose.

Demos prides itself on being a wholly independent and non-partisan political think tank. It has established a reputation for high quality research across a range of fields and an ability to maximise the impact of that research with media outlets and policy makers. The UK needs an organisation that provides in-depth analysis yet can still communicate lucidly about complex issues with mass audiences—it needs a financial services think tank.

Andrew Lodge was until recently an economist and policy advisor at HM Treasury working on the financial crisis response. Most recently, he was on secondment as a Senior Manager at UK Financial Investments.

978-1-909037-20-5

For more information about Demos Finance contact
demos.finance@demos.co.uk or 020 7367 4200