WHAT CAN BE LEARNED FROM THE **KAY REVIEW?**

Written 08/11/2012

In August 2011, the English economist John Kay[1] was appointed to establish an Advisory Board. His role was to produce a complete report on the current short-termism seen in the English markets and the dysfunctional nature of agency relationships within the investment chain. The main finding of the Kay Review is rather alarming: the players in the investment chain have lost sight of their main mission in the equity markets, namely to know how to guarantee the performance of companies and to generate returns for savers. Also, markets are suffering from a lack of confidence which is preventing companies from meeting the expectations of shareholders and savers.

Why this report?

The Kay Review was a follow-up to the consultation proposed in October 2010 by the Department for Business Innovation & Skill entitled 'A long-term vision for British businesses'. This first consultation explored the issues of short-termism in the United Kingdom, as well as other corporate governance-related challenges, focusing particularly on executives' remuneration.
The responses received from this consultation revealed the extent to which **short-termism is prevalent in UK equity markets, and also the dysfunctional Agency relationships within the investment chain.**

As a result, Vince Cable commissioned the economist John Kay in August 2011 to establish an Advisory Board to produce a more detailed report on these issues, identifying the specificities and relevant areas of reflection on the matter. In addition to John Kay, the Advisory Board is made up of Sir John Rose (former Chief Executive of Rolls-Royce), James Anderson (Baillie Gifford associate and manager within the Scottish Mortgage Investment Trust), and Chris Hitchen (Chief executive of Railways Pension Trustee Company and president of Pensions Quality Mark). Throughout the writing of this review, the Board benefited from regular contributions from a group of experts.

Initially, the Advisory Board issued a consultation between September and November 2011. This 'call for evidence', which received more than 82 responses, led to a better understanding of the major issues to incorporate into the report. The intermediary report, which was published in February 2012, recapitulated the responses obtained following the consultation and outlined the preliminary conclusions to be discussed in more detail in the final report, published in July 2012.

(1) John Kay is a British economist, a professor at the London School of Economics, and a regular contributor to the economic columns of the Financial Times. His latest work, entitled 'Obliquity – Why our goals are best achieved indirectly' came out in 2010.

Findings

➜ **Markets are disconnected from the economy and corporate finance.**

First of all, the review highlights one of the major flaws in the UK equity market.

An efficient market is supposed to improve corporate performance whilst generating revenues for savers. As the report suggests, **this long-term logic functions if the profits made by the best performing companies are the only source of revenue for savers who, in turn, invest in share ownership.**

And yet, the stock market has become a minor source of finance for corporate investments: the primary capital allocation system is carried out within the company; the main source of funds is the cash-flow generated by the company itself, and the use of these resources is determined by company management. This phenomenon has been developing over the last thirty years in Europe, and is thus relatively recent, which explains why savers no longer participate in the economy or corporate finance as they did before.

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Moreover, equity market fragmentation and the use of debt make direct engagement with companies relatively difficult. Therefore, encouraging engagement with institutional investors and favouring good corporate governance is crucial for the equity market. The efficiency of modern markets depends entirely on their capacity to promote these specific aims and thus defines a long-term logic necessary for the success of British companies.

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➜ **Asset management, at the heart of the system**

Next, the report deals with asset managers by underlining the importance of their contemporary role in the equity markets today, through their 'share ownership'.

The concept of 'ownership' is complex and raises several important questions:

- Whose name is on the share register?
- For whose benefit are the shares held?
- Who makes the decision to buy or sell a particular stock?
- Who determines how the votes associated with a shareholding should be cast?
- And finally, who holds the economic interest in the security?

The last two questions relate back to the fundamental shareholder rights that asset managers are now more and more willing to undertake.

As a result, we understand why **asset managers' activity needs to be controlled: as described earlier, they must ensure the effective functioning of the market.**

As the report states in its fifth chapter, **asset managers were traditionally promoters of a long-term vision, buying positions that they held for a long period thereafter.** Hedge funds, on the other hand, favour a short-term vision that many managers have tended to adopt as a result. This is why it is important to distinguish between those who are behaving as traders and those who are genuine investors within the asset management sector.

To Professor Kay, **public policies aiming to regulate the market should evaluate asset managers' activity** (particularly those who have the role of traders) in light of their potential to fulfil this double market objective of:

- fostering long-term decision-making on behalf of companies
- allowing savers to carry out financial operations in agreement with their objectives.

➜ **Erosion of trust**

To achieve these objectives, it is vital to establish a relationship of quality and trust amongst all players in the investment chain.

The report highlights how the trust placed in financial intermediaries has decreased over the last five years, not because of a negative perception on behalf of the public, but rather because of an actual breakdown of the system.

The short-termist culture favoured high-frequency transactions and anonymity, which led to a lack of understanding between asset managers and savers.

Add to this the fact that engagement is not encouraged: it represents, for example, an additional cost for asset managers, as they would need to commit resources to this kind of dialogue, while the profit from such an initiative would go beyond the limit of actions which would benefit the whole company.
All of the above-mentioned factors tend to encourage 'exit' rather than 'voice', to use the terminology of Albert O. Hirschman.[2]

> Within the asset management sector, it is important to distinguish between those who are behaving as traders and those who are genuine investors.

The structure and the regulation of the markets at the start of stewardship have become superficial and of poor quality, which is deplored by certain interlocutors approached during the writing of this report.

Recommendations

Among the 17 recommendations[3] mentioned in the report, those below seemed to us to be the most interesting:

➜ **Support the development of responsible share ownership that is not geared only towards corporate governance**

(2) Albert O. Hirschman, 1970, 'Exit, Voice, and loyalty'.

Stewardship is a crucial duty that asset managers have to undertake. However, as asset holders, their responsibility goes beyond governance-related issues.
The report issues an interesting first recommendation: the Stewardship Code needs to be strengthened in terms of an expansion of the asset holders' field of activity, in order to integrate strategic issues such as the company's key competences (the analysis of which can indirectly facilitate long-term decision-making).

This code can be strengthened by the implementation of non-binding Good Practice Statements to which company directors, asset managers and asset holders could volontarily follow.
This could promote a more responsible attitude and encourage the players in the investment chain to comply with them. A model of principles for each professional category is thus proposed later on in this report.

> ‘ Asset managers should take greater responsibility with regard to engagement. As for asset holders, their responsibility goes beyond that of governance-related issues.

➜ Encourage group actions

Encouraging collective initiatives would also represent a way of making players in the investment chain more responsible and more involved in the ownership of their assets.

However, regulatory obstacles often cause a hindrance to such collective engagement.
The report therefore recommends the establishment of an investors' forum, completely separate from the government, while advocating a certain flexibility regarding the format and terms of membership. Unfortunately, it does not provide any further details on the matter.

The British government, with the help of such an initiative, would show, not only that it authorises such collective actions, but, better still, that it encourages them.

With regard to the structure of this forum, it should remain very flexible so that it can easily react to major issues for investors in general, or for certain companies in particular.

➜ Increase communication and transparency

Several recommendations focus on the necessity for asset managers to reinforce their communication and transparency policies.
Amongst the most interesting suggestions, the eleventh one in particular deserves to be looked at in more detail.

The report considers that the information overload in the current slide in the market is the result of excessively heavy regulatory constraints.

Indeed, in response to the increasing demand to reinforce transparency, much information is aimlessly produced without there being any real interest in the evaluation of companies' long-term strategies. What is more, it is often the case that useful information is buried by the sheer volume of irrelevant data.
The report quotes the example of the Enron fraud, where the details were contained in regulatory filings, but these filings were so voluminous that the details went unnoticed.

Thus, a focus is required on information adapted to businesses' investment horizons. For example, the evolution of the building industry can only be appreciated in terms of a complete economic cycle. The same applies to banks, as the recent financial crisis has demonstrated.
Multiplying the quarterly reports or annual quantitative standards is not a good way of encouraging a long-term strategy. Obligatory quarterly reports should be removed while information transmitted to asset managers and shareholders should be qualitative instead of statistical, and should adopt a format specific to each company.

Moreover, several recommendations touch on the content of what should be communicated. With regard to asset managers, they should make the whole of their management fees public, including those associated with an asset disposal strategy.

> ‘ Multiplying the quarterly reports or annual quantitative standards is not a good way of encouraging a long-term strategy.

More transparency on the issue of asset lending would be appreciated. The Investment Management Association (IMA) consultation on the matter, published on the 20th September 2012, was eagerly awaited. It revealed useful recommendations in terms of publications that should be added to European regulations.

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(3) Can be found via the following link: http://www.bis.gov.uk/assets/biscore/business-law/docs/k/12-917-kay-review-of-equity-markets-final-report.

An interesting area for reflection is proposed in the fifth recommendation, which encourages businesses to engage in a consultative dialogue with their principal shareholders, particularly regarding boards of directors. The above-mentioned shareholders' forum should facilitate the creation of such initiatives.

Unfortunately, the report does not dwell on the issue of remuneration discussed in the eleventh section of the report. In fact, the topic was already to a large extent tackled by the Business, Innovation and Skills Minister throughout a consultation on the strengthening of shareholders' voting rights launched in March 2012, which helped define the framework for reforms announced by Vince Cable on the 20th June.

Two recommendations are to be highlighted:

- The first concerns companies, in that incentive mechanisms must be aligned with the idea of the long-term performance of a business. Although long-term plans are being more and more put into place, their length is generally inappropriate because they stop at the end of executives' terms. Most strategic decisions have an impact which goes far beyond executive mandates.

- The second important recommendation is more related to asset managers' bonuses. Indeed, asset managers should align remuneration of their managers in the interests, and on the timescale, of their clients, in a way that does not associate remuneration with either fund or asset manager performance in the short term.

What can we expect from this report?

Few indications have been given as to what to expect from this report. Vince Cable stated that he would give a response after a closer reading of the full content.
One can only hope that, under the auspices of the Minister, this report will lead to new legislation on the themes discussed. Of course, **asset managers are encouraged to implement the various recommendations** presented as soon as possible, though in the absence of strong impetus from the government or from a British corporation, the chances of the situation evolving seem very slim.

What should be drawn from this?

The main observation is rather alarming: players in the investment chain appear to have lost sight of their main duty in the equity market, namely guaranteeing corporate performance and generating revenue for savers.

The markets are therefore suffering from a lack of confidence, stopping companies from satisfying the needs of their shareholders and savers.

In reiterating the necessity of making asset managers take responsibility for their actions, this report is comforting in that the idea of socially responsible investment is a way of rethinking the functioning of the market according to a long-term strategy. It also offers interesting avenues of reflection for asset management and highlights opportunities related to this profession today, to redirect the markets towards sustainable perspectives.

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