ENGAGED CAPITAL AND INVESTMENT IN PRODUCTIVE ASSETS

Jonathan Oppenheimer, February 2020[1]

In the early part of 2020, the international monetary system is under stress. Persistent low interest rates threaten macroeconomic and financial stability and are contributing to rising inequality. Raising the rate of investment in productive assets is essential to address these problems and to increase economic growth rates globally. Raising investment rates is also needed to address the social problems that threaten political stability in some of the world's poorest countries.

If we are to raise the rate of investment in productive assets, we must change the relationship between financial investors and the company managers who are responsible for productive investment decisions. The majority of financial investment is either in the form of passive funds which track indices and take a hands-off approach to company management, or transactional capital deployed by traders who are focused on technical factors rather than the fundamentals that create long-term value.

To address this problem, we need a radical change in financial investor mentality. More engaged capital is needed. Engaged capital is the key to ensuring that company managers have the space needed to make sound decisions to add to productive assets in the pursuit of long-term value.

What is engaged capital?

If the relationship between financial investors and company managers is to be productive, they must have the right incentives to engage with each other and build a sustainable relationship. Engaged capital is a form of investment that involves a partnership between financial investors and company managers, with a shared long-term horizon and a focus on maximising sustainable value. There are three conditions for this: patience, scale, and tolerance of risk.

Financial investors must be ***patient*** to provide company managers with the correct incentives to invest in productive assets with a long time horizon. This should not be a blind commitment to a long holding period, but rather a willingness to base buy or sell decisions on a long-term view of company strategy and performance. This means putting less emphasis on quarterly financials. It requires analysis, dialogue, and a willingness to see through short-term fluctuations in equity prices.

This is only likely if the financial investors hold ***meaningful stakes*** in individual companies. This provides them with ***skin in the game*** to incentivise engagement and the acquisition of intangible, long-term information about company decision-making. This also allows financial investors to ***influence*** strategic decisions and to ensure company managers are not distracted by other influences, such as hitting quarterly earnings forecasts.

Higher risk – rewarded by higher expected returns - also incentivises financial investors to engage more. Moreover, the higher expected yield in return for the higher risk makes this more attractive to investors in a low interest rate environment.

[1] Analytical support provided by Global Counsel.

Why do we need more engaged capital?

More engaged capital is the key to encouraging investment in productive assets and this is essential to address several of the most pressing challenges facing the global economy.

A shortfall in investment relative to strong global demand for savings has driven down interest rates. Long-term interest rates have been falling around the world for over three decades and a large amount of sovereign debt is now issued with negative yields. There is less room for central banks to use monetary policy to offset downturns in the economy when nominal rates are close to the lower bound. There are also concerns that low rates are fuelling asset price bubbles, with equity prices at record highs.

For several years we have seen strong investment in productive assets in China and to a lesser extent in other parts of Asia. But this has not been matched elsewhere. The rate of investment in productive assets, measured by gross fixed capital formation, has fallen in sub-Saharan Africa since the financial crisis of 2008. And globally the desire to save more has proved stronger than the desire to commit capital to productive assets.

While Africa is the world's single demographic bright spot, it has failed to attract its fair share of investment. For much of the past three decades, growth in the global working-age population has been driven by China; thirty years from now it will be driven by Africa. Much more engaged capital is needed to channel investment to areas with the greatest need and opportunity, like sub-Saharan Africa.

A combination of transitory and longer-lived factors is encouraging savings while restraining investment.

Structural factors include the need for rich countries to save more as their populations age. Many emerging economy governments want to save more and hold a higher stock of reserves to protect against economic shocks. Households in countries with weak social safety nets want to save more for precautionary purposes. Firms in countries with under-developed financial systems and few hedging options want to save more for similar reasons.

Higher demand for low-risk assets globally pushes down their return. The institutional mandates of life assurers require them to hold more safe assets even as the yield decreases. With the growing focus on ensuring the resilience of financial institutions through proscriptive regulations since the financial crisis of 2008, regulators are driving an increase in demand for low-risk assets which has not been matched by greater supply, contributing further to the fall in interest rates.

Increasing inequality can explain some of the upward pressure on savings. The rich tend to save more of their income, so rising income inequality will lower consumption and raise desired savings. To some extent the rise in inequality in market incomes is being masked by social spending which is increasingly burdensome. If this is unsustainable, it will add to the pressure on inequality and therefore savings.

There appears to be a negative feedback loop between low interest rates, wealth inequality and savings, adding to the downward pressure on interest rates. Low interest rates tend to push up asset prices and therefore the financial wealth of asset holders. Financial wealth from savings, property, and investments therefore becomes increasingly concentrated in a smaller proportion of wealthy households who consume less and save more.

An increase in the perceived riskiness of investment, combined with risk aversion by financial investors, could also act as a constraint. Investment may be perceived to be riskier because of uncertainty about future productivity growth or other factors affecting the desired level of investment. Political uncertainty – with concerns about protectionism, the US-China relationship and Brexit – could be contributing to this. Regulatory frictions and uncertainty are also likely to be constraining investment.

Taken together, the forces driving interest rates lower are more structural than cyclical and are therefore likely to be sustained. Action by policymakers and by investors is needed to rectify the situation. It won't be self-correcting. The best way to address the problem is to raise investment rates in productive capacity globally. And the key to do that is to encourage more engaged capital.

How can more engaged capital help?

The private sector has a critical role to play in raising the rate of investment. Global corporate savings have surged in recent years. The problem is not a lack of funds, but the incentives that financial investors and the financial system bring to bear on the company managers who must decide whether and when to invest in productive capacity.

For a given profit after tax, capital expenditure must compete for funding with dividends, buybacks and changes in the net financial asset position on a company's balance sheet. Dividends, buybacks and cash holdings have increased in recent years, when investment has been subdued.

An excessive focus on providing a regular flow of dividends to financial investors may be holding company managers back from undertaking productive, value-enhancing investments that benefit shareholders with a long horizon. There is also evidence that too much executive time is taken up by managing quarterly earnings announcements. Efforts to hit analyst forecasts may be constraining investment. Executive incentive schemes may be holding back productive investments, particularly when equity is about to vest, as some company managers may be more focused on meeting EPS targets.

Engaged capital can help as it implies a different relationship between financial investors and company decision makers. Informed and committed financial investors are more able than anonymous traders or passive investors to encourage company managers to focus on long-term value. Providers of engaged capital, who through analysis and dialogue understand and support – where merited – the strategy of a company, are more likely to see through short-term fluctuations in share prices.

What can be done to encourage more engaged capital?

Policymakers, financial investors, debt providers and company managers can all help to encourage more engaged capital.

Policymakers should assess the impact of their actions on the incentives of financial investors. Regulatory frictions and governance practices that inhibit engaged capital should be justified by other public policy objectives or removed.

Policymakers should reconsider the merits of promoting liquidity through ever greater trading volumes. This may encourage high-turnover trading strategies and the financialisation of the economy at the expense of engaged capital. It encourages a focus on price discovery at the expense of value discovery, which is what matters most if we are to raise investment in productive assets.

Direct equity stakes by financial investors provide the closest possible link between financial investors and company managers. These are, however, the most resource-intensive form of engaged capital investment, which is why financial investors must be willing to build large enough stakes to make this attractive.

The need for patience, scale and tolerance of risk means engaged capital is not naturally a fit for individual retail investors. However, policymakers should create frameworks to allow the long-term savings of retail investors to be collectively channelled into engaged capital. This would support investment in productive assets, while potentially boosting the value of retirement savings by allowing retail investors to access private or direct equity-like returns.

There needs to be more scrutiny of incentive schemes for company managers to see if these are constraining investment, particularly when equity is about to vest. Some executives may be more focused on meeting EPS targets and forgoing productive investment opportunities. Similarly, more attention should be given to how asset managers are rewarded.

More widespread use could be made of stewardship codes and further attention given to how these promote engaged capital. The proper scrutiny of corporate investment decisions and their long-term impact should be central to this.

Providers of engaged capital, including generational family offices, should play a bigger role in encouraging the asset management industry to engage company managers more on their investment decisions. Family offices, sovereign wealth funds, and other large institutional investors are often well-positioned and resourced to act as engaged capital investors. Managing intergenerational or national wealth inherently entails a patient outlook, normally allows for significant risk tolerance, and frequently requires only a small portion of total assets under management to be held in liquid or short-term assets for income distribution. Creating sustainable value through long-term engaged capital investments also typically aligns with family legacy goals.

Annex: Defining and measuring engaged capital

Fig 1: What is engaged capital?

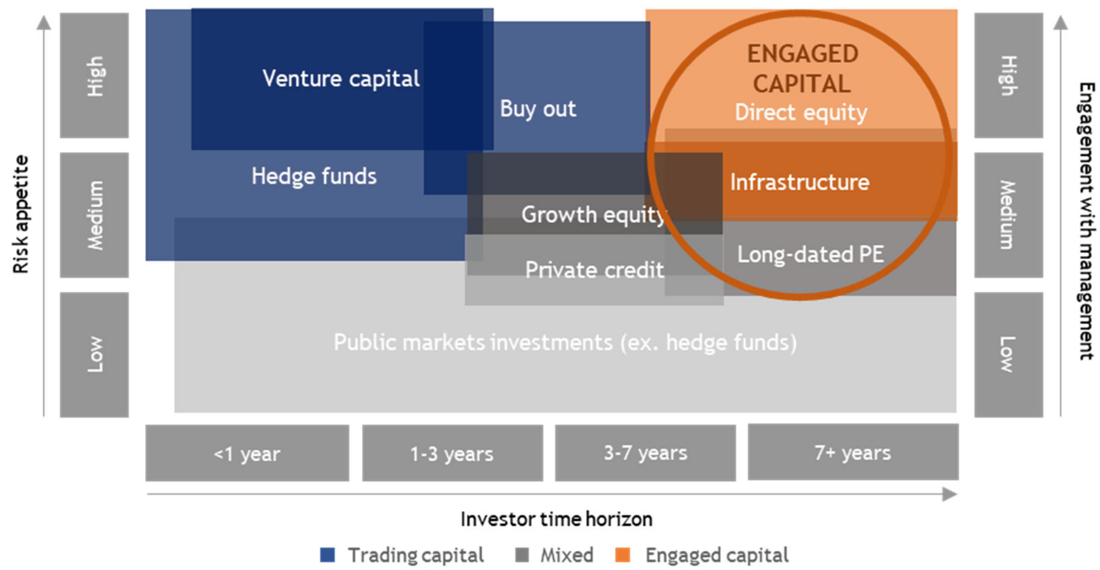
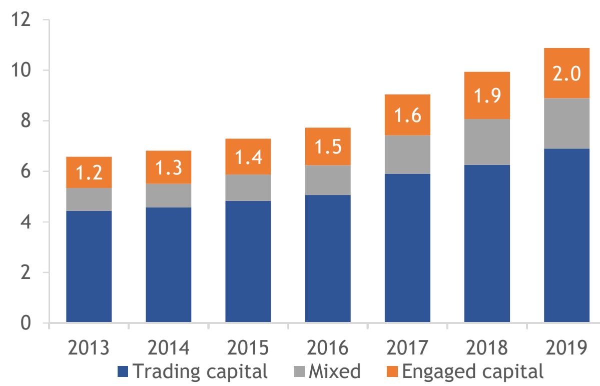


Fig 2: Alternative assets by type

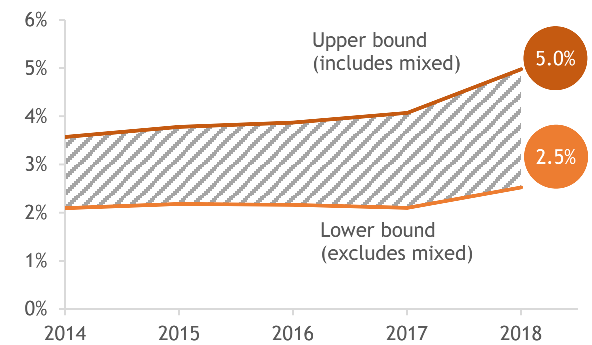
Assets under management, $ trillions



Source: Preqin, BarclayHedge, GC calculations

Fig 3: Engaged capital in context

Engaged capital held in private assets, % of global AUM



Source: Preqin, BCG, BarclayHedge, GC calculations

Financial investor strategies that fall within our definition of engaged capital include direct equity stakes and infrastructure funds. Some long-duration, growth equity and private credit funds also fit our definition, but not all. These fund types are classified as mixed above. A small subset of the long-only fund management industry would meet this definition, depending on their level of engagement with company managers.

Our estimate of the proportion of assets under management that meets our definition of engaged capital ranges from 2.5% (narrow definition) to 5.0% (with mixed assets included) of total assets under management. This proportion has grown in recent years. It does not, however, take account of the likely small amount of public markets investments that meet our definition of engaged capital.