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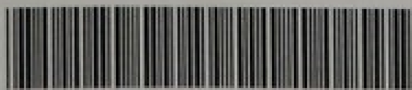

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INNOVATION: CITY ATTITUDES AND PRACTICES

INTRODUCTION

1. Last year members of DTI's newly established Innovation Advisory Board expressed their concern to the then Secretary of State for Trade and Industry over City attitudes to innovative investment, including the negative effects on companies of increasing "churnover" by fund managers.

2. Such concern prompted the IAB to give priority to a review of how the "company/City interface" affected UK innovative performance. As the IAB secretariat we carried out a survey of City attitudes and practices relating to innovation, through discussions with individual brokers, fund managers, consulting actuaries and others suggested by the Bank of England.

3. Given previous major reports from, for example, the 1987 City/Industry Task Force, our ground already appeared well-tilled. But we were soon impressed by the scepticism over the impact of such earlier reports and the genuine concern in the City over "short-termism", which one senior fund manager described as:-

> *"a fundamental flaw in our economy that if not addressed would lead to a continued loss in the UK's international competitiveness".*

4. The relevance of our survey was also confirmed by:-

(a) **UK comment** — a year after the 1987 CBI report of the City/Industry Task Force, more rather than fewer companies (64% of all companies and 79% of large companies), considered that the financial institutions did not take a sufficiently long-term perspective when making strategic evaluations of UK companies (1); by 1990 more than 90% of UK finance directors considered the City was excessively preoccupied with short-term earnings and share price performance (2);

(b) **European comment** — at a 1989 Brussels conference (3) it was suggested that the key question for the future of Europe was not "1992", nor European Monetary Union, but the type of capital markets, and whether they would be "unfriendly to innovators" like the UK and US markets with "easy" takeovers and a preoccupation with short-term profits, or more in tune with innovators like the markets in Germany and Japan with banks and institutions in close relationships with company managers;

(c) **US comment** — an official 1990 report on the troubles of US industry suggested that US companies were "hobbled" by a financial environment undervaluing long-term investment, and advocated, inter alia, fiscal incentives for investors to hold investments longer (4); leading Senators have also proposed taxes on short-term gains by pension funds through an "Excessive Churning and Speculation Act" (5).

5. Our findings are based on the impressions we gained from helpful and entertaining discussions with some fifty City practitioners (some of whose unattributed quotes we have included), and from following the almost daily flow of relevant events, comments and studies. Our report is structured as follows:-

II — How UK innovation performance has fallen behind our competitors, with one factor apparently being the sacrifice of R&D in favour of dividend payments to forestall takeovers.

III — How brokers, analysts, fund managers and the financial press fail to give innovation sufficient and consistent priority.

IV — Suggestions for introducing that priority through various steps to give more prominence to innovation plans, but with accompanying changes in the practices of the institutions.

V — How the institutions have grown to positions of enormous influence, and how certain practices, of the externally-managed pension funds in particular, appear to be fuelling short-termism.

VI — Suggestions on how the pension funds might be "pivoted" away from such practices through voluntary changes in their practices, and through changes in the fiscal and takeover frameworks.

VIII — A summary of conclusions and suggested actions involving industry, the institutions and Government.

II UK INNOVATION PERFORMANCE AND DIVIDEND PAYMENTS

6. Although our study is concerned with all innovative investment, our focus is on Research and Development as it affects the profit and loss account and is thereby particularly vulnerable to short-term thinking. Other innovative investments, for example training and design, are similarly vulnerable to short-term thinking but fewer statistics are available. Nevertheless many of our arguments and recommendations apply equally to these "intangibles".

7. The IAB's theme

"Innovation is vital to profitable and sustainable growth"

is set out in a separate publication (6). Reports, such as that by Deloittes (7), have suggested that many UK industrialists give insufficient priority to innovation; international comparisons bear this out:-

Business Enterprise R&D financed by industry, 1975-87

	% annual increases (constant prices)
Japan	9.3
West Germany	6.6
US	5.4
France	5.1
UK	3.6

8. The cumulative effects of such under-performance in the UK has been illustrated by a recent survey (8) which shows, for example, that 71% of West German companies spend more than 5% of their revenue on R&D, compared with only 28% of companies in the UK. More detailed sectoral analysis (see Annex A) shows that in recent years trends in UK business enterprise R&D (including Government funding) have diverged dramatically:-

Total Business Enterprise R&D, 1985-88

	%annual increases (constant prices)
Chemicals and pharmaceuticals	13.1
All other manufacturing sectors (overall)	- 0.1

9. R&D in manufacturing sectors other than chemicals is far from unimportant. One estimate (9) of international R&D "intensities" puts these at 20% of the value of sales in the electronics sector, 12% in motor vehicles, 10% in mechanical engineering, as compared to 14% in chemicals. Moreover, the sectors other than chemicals and pharmaceuticals account for three-quarters of UK business enterprise R&D.

10. Why has UK R&D performance (in most sectors) been so relatively poor over the past decade and a half? Does part of the answer lie in the priority given by companies and the City to dividend payments? As long ago as 1979 a Financial Times editor (10) warned that the UK practice of giving preference to dividend payments over expenditure on R&D (contrasting strongly with German practice) had

> *"proved deadly to a long list of familiar names in manufacturing, and might soon kill off entire industrial sectors".*

11. Yet this warning of the dangers of short-termism appears to have gone largely unheeded. Many observers appear to have more readily embraced a 1985 US study (11) which examined particular relationships (eg levels of R&D and percentage of equity held by institutions) and found little to support short-term hypotheses. In contrast, a UK study (12), pointing to the UK stock market attaching an extraordinarily high weight to current dividends, attracted less attention.

12. We thought it worth looking more closely at the recent "static" R&D performance of the UK non-chemical sectors. In fact over this period Government support has been reduced and industry's own spend in these sectors has increased by 2 to 3% a year. Yet that increase still seems surprisingly low given the sharp increase in profitability in the later 1980s. We looked at the increases in profitability and dividend payments of the top 20 R&D spending companies in the sectors other than chemicals, ie electronics, aerospace, mechanical engineering, and others, arriving at the following comparisons:-

	% annual increase, 1985-88 (constant prices)
Business Enterprise R&D financed by industry in sectors other than chemicals (overall)	2 to 3
Profitability of top 20 R&D spending non-chemical companies	10
Dividend payments of those top 20 companies	16

If the above dividend payments had increased half as fast, ie at "only" 8% a year in real terms, R&D could have been increased at about 5% a year, ie at double the rate actually achieved.

13. Seemingly a clear preference for dividend payments (rising at a striking 16% a year in real terms) over R%D has meant that many UK companies failed to use the higher profitability of the later 1980s to make step-changes in their R&D levels to catch up with or perhaps even outstrip their competitors. The takeover fever of the late 1980s appears to have been responsible. The numbers of takeovers in manufacturing sectors other than chemicals rose from 234 (£3.2 billion of acquisitions) in 1985 to 593 (£6.7 billion) in 1987. In contrast, in the chemicals sector, where spend on R&D increased strongly, takeovers were relatively

insignificant - only 17 (£0.2 billion) in 1985 and 16 (£0.1 billion in 1987). Much of the surge in R&D in the chemicals sector was attributable to one major company, which actually increased its dividends at a slower rate (11%) than many other manufacturing companies (n.b. the 16% average above). Asked how this had passed City scrutiny, a chemicals sector analyst observed that the company concerned was virtually takeover- proof, due to its size and national importance.

14. A recent Policy Studies Institute publication (13) has highlighted this "dividends versus innovative investment" issue as a critical question facing UK and US companies:-

> *"Should financial strength be sought by paying higher dividends to avoid takeovers or should the emphasis be on finance for research and innovation so that the product range can be continuously updated?"*

15. The UK situation, which features dominance by institutional shareholders and the facility for contested takeovers, may have much in common with the US situation described as:-

> *"Companies have cut back on research and capital spending to maximise short-term profits and ward off raiders. That rips right into the heart of American competitiveness" (14).*

16. But there are prior questions to be answered:-

— why does the company/City interface lead to such a comparative marking-down of innovative investment?

— Are there particular City practices which encourage such marking-down by focusing on short-term returns?

— What can be done to give innovation what we believe is its proper priority, including the modification of any damaging practices, possibly through changes in the fiscal and takeover frameworks?

III ATTITUDES TO INNOVATION

17. Most City practitioners we met were not particularly interested in discussing innovation and its implications. To them, R&D seemed very much a secondary factor. Indeed one senior fund chief strongly advised that we should drop the expression "R&D" because the City would never warm to it, and instead use "product development" as a more acceptable expression. We felt that would amount to avoiding the issue.

(a) R&D and brokers

"The market does not under-rate or over-rate R&D; it does not rate it at all".

"Companies do not report R&D on a consistent basis. Therefore we can attach little weight to it".

18. We were told that share prices are strongly influenced by recent profit performance and prospective earnings over the forward 12—18 months. The "quality of earnings" factors such as gearing, management, market-share, product development and competition are also very relevant. One broker considered that R&D "tends to be subsumed" amongst such factors; another said that R&D could be an additional subjective factor, for example with pharmaceutical companies.

19. Brokers look for sector-typical annual growth in profits, and companies wanting favourable brokers' reports must know that profit performance and outlook should have priority over other factors. As R&D is charged to the profit and loss account it could only inhibit earnings growth in the short-term, and indeed some sections of the City apparently consider R&D simply as a cost.

20. Another reason suggested for the "non-rating" of R&D was that until the recent requirement under SSAP 13 there had been no obligation to disclose R&D in company accounts. Brokers have been sceptical of company claims of R&D spend without definition or audit.

21. Finally, it was suggested that the performances of major firms in the electronics/telecommunications industries had led some in the City to look with a jaundiced eye on "technology" generally. It was alleged that in these sectors some companies had opted for contracts with MoD or BT rather than produce internationally competitive products, a preference which suggested decidedly short-term thinking within those companies. As a result UK growth in these technology-based industries had been dwarfed by the expansion of European competitors. (But see also comments below about analysts in the electronics sector).

(b) R&D and analysts

22. A recent study of how the City appraises technology investments (15) concluded that many City organisations do not believe that understanding the technology itself is of major value. Evidence of past management success is for them an adequate testimonial for new technology, though they might then be accused of being "informationally inefficient".

The study's sampling indicated that 16 out of 18 pharmaceuticals analysts and 9 out of 11 chemicals analysts were science graduates. In electronics the proportion was only 8 out of 25, despite more R&D being carried out in that sector than any other in the UK. Technological issues then mattered more in the pharmaceuticals sector than in the electronics sector because of the different extents to which analysts were "informed" about technology.

> *"Electronic analysts are less well informed about technology so share prices do not respond to public announcements about research; as a result a less deep understanding is needed on the electronics side".*

(c) R&D and Fund Managers

"R&D is not generally a topic in our annual discussions with companies. We don't get to that level of detail"

"R&D is poorly explained; companies try to classify it all as development, and are apologetic about research".

23. In their annual discussions with companies, fund managers typically cover trading performance, future product and marketing strategies, composition of the Board, management style, dividend policy, current issues (eg wage bargaining) and "shareholder value" points — ie steps that a company is taking to keep its share price attractive.

24. Only with companies like Glaxo (always quoted as the best example of a company where R&D is important) would R&D plans be a focus of discussion. We asked fund managers how they reacted to proposals for step-change increases in R&D. (Their reactions suggested that such proposals were rarely put forward). Some fund managers took the view that they would be accepted from "good managers", with proven track records. Others, more in the "aggressive" mould, commented that stability in cash flow would be a key factor (which apparently might rule out some engineering companies). Furthermore, a step-change increase in R&D, bringing with it a possibly depressed share price, would have to fit in with the management of the particular portfolio. Finally, if the company "under-performed" for more than say a year, we were told that the "aggressive" fund manager would sell his holding, perhaps leaving the company to be picked off by a predator.

(d) R&D and the financial press

25. We were also surprised at the brief and infrequent mentions of R&D and other innovative investment in discussions of annual or half-yearly company results by publications like the Financial Times and Investors Chronicle. Even in reports on the higher spending R&D companies discussion or even mention of R&D is more the exception than the rule.

26. In such a climate, the reception given to more ambitious R&D plans may be at best uncertain. It is often claimed that companies that present their proposals well will get institutional backing. But companies themselves refer to the variations in attitude and fickleness of City commentators and the very numerous fund managers. A recent survey (16) has indicated that 36% of the UK manufacturers sampled believed City analysts had an adverse impact on their R&D investment decisions, citing concentration on short-term profits as their reason.

IV GIVING INNOVATION THE RIGHT PRIORITY

"The UK needs a crash programme to increase civil R&D expenditure" (17)

27. According to the above viewpoint from a City economic adviser the long-term decline in UK technological competitiveness threatens future UK membership of the group of advanced industrial countries.

28. Arresting this decline will require various steps to be taken. Managers must devote more of their efforts to innovation. The development, training, and reward of scientists and engineers will have to be improved. But changes in the company/City interface are also essential. Priority needs to be switched from dividends (providing short-term support to share prices) to innovative investments (which increase market shares). In some sectors, eg UK chemicals (and, in the US, motor vehicles) greater priority has been accorded to innovative investments. But more sectors need to follow suit. As one US analyst has recently commented:-

"Market share, being creative with new technology, exploiting new niche opportunities, is going to be the key to challenging the Japanese in the next few years" (18).

29. Moreover, improvements in the climate for innovation should be designed to pave the way for **step-changes** in levels of innovative investment. Whilst the search for innovative advances should be unceasing, jumps to higher levels of R&D and other innovative investments are needed when inventions are exploited, new areas tackled, or activity levels raised in response to competition.

30. The following developments would help give innovation the necessary priority at the company/City interface:-

(i) **publication of an R&D scoreboard**

— the opportunity presented by the disclosure requirements of SSAP13 should be taken to draw up a "UK R&D scoreboard" by sectors and companies, as is published in the US by "Business Week". That scoreboard shows for each company R&D spend against employment, sales and profits, and ranks companies within sectors.

— The further development of an "international scoreboard" would help companies to justify particular increases in R&D levels, and perhaps also indicate possible trimming of R&D to boost short-term profits.

— Eventually similar scoreboards might be drawn up for other innovative investment, including spend on training and design.

(ii) **better company presentation of R&D and other innovation plans**

— clearly companies will have to devote more effort to demonstrating how their R&D plans can lead to those future "products of the year" acclaimed by City management magazines, partly through reference to past R&D successes. There is a surge of interest in "Investment Relations" for example with a CBI guide (19) and an independent publication (20), but both appear somewhat lacking on innovation issues.

— The CBI guide specifically refers in its foreword to "long-term competitiveness depending on investing in people, plans and technology" and to the need to persuade shareholders "that they should take a long-term view of the business". The pamphlet then deals at length with the audiences companies should address but says nothing on how to get across the value of investing in people, plans and technology — seemingly a key purpose of the exercise. The independent publication, a lively and well-received book, makes only passing reference to innovation under "window dressing" — "if your cashflow is weak, explain that R&D spend is high and then point to your 'research-to-launch' ratio to show your potential".

— more specific guidance is needed if companies are to make the improved presentation to shareholders of innovation plans, and, in particular, of plans for step-changes in innovative activity.

(iii) **analysts capable of assessing innovation plans in all sectors**

— industrialists have told us of their frustration in trying to explain innovation plans to uncomprehending analysts, and the study referred to in paragraph 19 indicates how this could happen in particular sectors.

— we found this a somewhat sensitive and controversial issue not only because of some firmly held "know the management not the technology" views, but also because of the argument that scientists are better employed out in industry rather than in the City.

— nevertheless, if innovative investment is to be accorded higher priority the "informational efficiency" of chemicals sector analysts is an example to be followed in other sectors.

(iv) **innovation plans as regular topics for company/institution meetings**

— athough one institution commented that reviewing technology strategies would "amount to a revolution in its practices", we believe R&D and other innovation plans should be regular topics at the annual meetings institutions hold with companies in which they have important shareholdings. The institutions should also be sufficiently informed about the technologies involved, and competitors' efforts, and not simply

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take the view that "good managers can be relied upon to back innovation sensibly". Surveys and the R&D data suggest that many company managers have not given, and still are not giving, a sufficient priority to innovation. A key test for good managers should be how convincing they are at explaining prospective returns from their innovation plans, with back-up analysis of returns from previous investments where possible.

31. Yet even if the above steps were taken we believe that the resulting benefits would be limited as long as the market-makers focus on the short-term and the practices of key institutional shareholders support such a short-term focus.

V PRACTICES OF KEY INSTITUTIONAL SHAREHOLDERS

32. In the mid 1960s the UK's R&D performance was second only to that of the US. "Householders" then held two-thirds of UK equities and the institutions only a quarter. By 1990, the UK's R&D performance had slipped considerably against international competitors (now below Japan, Germany, the US and, on some counts, France). Over the same period institutional holdings of UK equities have risen to some 70%, and householder holdings have fallen to less than a sixth. These parallel developments could be mere coincidence, but possibly not.

33. In the late 1970s it was suggested (21) that:—

> *"The institutional shareholders are overwhelmingly interested in companies' long-term performance, rather than in short-term dealing".*
>
> *"In effect, Britain may be quietly moving towards the German pattern of relations between industrial companies and their institutional shareholdings — a relationship which has much to do with the strength of German manufacturing. There, the shareholders (in this case the banks) recognise that short-term profitability cannot be a company's main objective".*

34 Unhappily the reality of the 1980s has been somewhat different. Our survey suggests a spectrum of attitudes amongst institutional shareholders, ranging from relatively long-term views of most insurance companies, internally managed pension funds and even some unit trusts, to seemingly shorter-term views of many external managers of pension funds.

35. Indeed, particular practices of the externally-managed pension funds appear to be fuelling, and possibly igniting, the short-termism of the UK equity market and thereby imposing damaging short-term policies on UK companies.

36 There are also few signs of institutional shareholders consistently and effectively playing the supportive role attributed to German banks. Instead there is now what is euphemistically called "Creative Tension" between companies and the institutions (discussed in the very useful NAPF booklet of that title) (22). Even those most closely involved (23) refer to the "deplorable decline in relations between the City and Industry during the last three years", and one fears that the tension could sometimes be more destructive than creative.

(a) the structure of the pension fund industry

37. The growth in the pension fund industry from £10 billion in 1970 to over £240 billion in 1990 has been spectacular. Insurance companies have also grown fast, and the financial institutions together hold a remarkable 70% of the UK equity market. As shown at Annex B no other country, not even the US, has institutional shareholders in roles of such dominance, and also of such influence.

38. With pensions and insurance liabilities firmly set in the long-term the London market might be expected to have a long-term orientation. If anything, the opposite appears to be the case. One senior fund manager commented that "the London market is perhaps the most short-term of all". The gross dividend yields of 5.0% in the UK and 3.5% in the US compare with 1.9% in Germany and 0.6% in Japan, (April 1990). Such figures suggest that shareholders in Germany and Japan are more patient.

39. The pension funds are owned by UK companies, public utilities and local authorities. Of the 40 largest (each with market values over £1 billion) about half are internally managed and half externally managed. Of the next 40, internal managers number only about a quarter, and further down the scale, where most medium-sized UK companies' pension funds are, internal managers become increasingly rare. In terms of numbers of funds, externally-managed funds account for well over 90% of the total, and, in terms of assets managed, over half of the £240 billion plus total.

40. The table at Annex C shows the activity levels and returns by types of fund manager, and indicates the numbers and values of funds handled by each group.

(b) **performance objectives for externally-managed funds with quarterly reviews**

41. Our focus is on the external managers of pension funds for reasons explained below. Their routine monitoring practices include quarterly performance reviews which involve triangular relationships between fund managers, consulting actuaries and trustees.

— **fund managers** — *"have been rather weak in allowing themselves to be judged over shorter performance periods"*

— *"if the portfolio starts looking bad the fund manager is under more pressure to go short-term"*

— **consulting actuaries** — *"have a lot to answer for"* (but hats off to them for gaining so much power in so few hands with so few people noticing!)

— **trustees** — *"some take remarkably little interest in the detailed performance of their fund managers"*

— *"among the trustees, the finance director usually dominates".*

42. Objectives for the "external" fund managers tended to be very general (eg to achieve the highest return consistent with the degree of risk appropriate to a pension fund with the cash flow and other characteristics of the fund in question), but it is now more common for objectives to require returns better than the FT Actuaries All Share Index, or better than the return of the WM sample of pension funds.

43. The nominal performance measurement period has tended to shorten to 2 or 3 years, but in many cases the period is even shorter as trustees (or their consulting actuary advisers) focus on quarterly reviews of performances against the FT index or the median of all funds. The turnover of external managers appears to be high; one fund manager claimed that, on average, funds changed their managers every three years.

44. Many of the fund managers we met were uneasy over the pressures arising from such quarterly performance reviews. One commented that

"fund managers are caught up in a game in which there can be no real winners".

Some resented the key roles which the handful of consulting actuaries have developed — ie those of appraising the performances of fund managers, of advising trustees on the desirability of changing managers, and of identifying and recommending the possible replacements. Others referred to pressures from finance director trustees looking for "pension fund contribution holidays" to boost their profits.

(c) **potential damage to companies arising from short-term pressures on fund managers**

— *"a perception is emerging that excessive attention to comparison between funds over relatively short time periods is leading to bad decision-making. Excessive short-term activity is bad for funds because of the costs incurred and is bad for companies because it can put the wrong kind of short term pressures on management"* Phillips and Drew 1989 (24)

— the "real cause of short-termism" has been described as follows:— *"if fund managers do see themselves as being under such short-term pressures it must preclude their taking long-term views of most companies in their portfolios and of establishing relationships with them. The more they are inclined to view the shares they hold as trading counters, the less they will be sympathetic to the longer-term view which is concerned with the underlying quality of a business and its management. It is perhaps this aspect of our system which is most deleterious"* — Bank of England 1989 (25)

45. The damage to companies may typically occur as follows:—

— **the shorter the performance period the more a fund manager will opt for shares likely to deliver the short-term profits esteemed by market-makers;** moreover, if his portfolio starts to under-perform the fund manager may go even more short-term; in response, companies give priority to the sought-after short-term profits (in order to avoid being "sells" with slipping share prices and prey to takeover merchants) in preference to R&D and other innovative investment;

— **high turnovers;** as shown at Annex C externally managed funds have average activity levels double those of internally managed funds; these make the damage more widespread so that very few companies can consider themselves insulated from short-term pressures, and the obligation to respond to them;

— **in takeover situations,** a leading external fund chief has acknowledged that:—

"It is true, generally speaking, that insurance companies, whose performance is not subjected to as close or as frequent scrutiny by their policy holders as the pension fund managers' is by trustees, have been more inclined to decline takeover bids" (26).

— External fund managers are then the more likely to take the "EXIT" (short-term profit) route rather than the "VOICE" (working with the existing management) route; such attitudes were probably key facilitating factors in the take-over fever of the late 1980s; if so, such attitudes will also have contributed to the defensive increases in dividends and limited growth of R&D in many sectors over the same period.

— Furthermore it has been claimed that takeovers, although often effective methods of correcting managerial failure, can lead to an offsetting form of short-termism though undermining relations between investors, managers and employees, which have taken time to establish:—

"Managers and employees may be denied the benefits of their firm-specific investments by changes in ownership. Faced with this risk, employees may be unwilling to incur the costs of investment in firm-specific training and managers may be unwilling to forego current earnings for long-term R&D projects" (27).

(d) **the obscurity of the benefits from aggressive fund management**

46. The analysis of activity levels and returns by the different groups of fund manager, (ie internal, four types of external fund managers, and combinations) show wide diversity in activity levels, but very little variation in return — see Annex C. The group with the (marginally) best return over the last 4 years is the "internally managed". It also has activity levels about half those of the externally managed groups. (A very small group, "life company managed", shares this position). The performance measurers assure us that there is no statistically significant relationship between activity levels and returns. One can conclude that, in aggregate, aggressive and high turnover fund managers bring nothing extra to their funds than more patient and lower turnover fund managers.

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VI PIVOTING THE PENSION FUNDS

47. If the externally-managed pension funds could be pivoted away from the particular practices discussed in this paper, City/industry short-termism would run short of fuel.

48. The overall merits of such a shift appear to be considerable. The practices in question — short performance periods, high turnovers, and relationships with companies of a fragility that is revealed in take-over situations — oblige companies to give priority to short-term profits and dividends at the expense of R&D and other innovative investment. Any offsetting benefits from such practices appear to be obscure, or even non-existent.

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49. In the United States, the only other major country with similar shareholder, turnover and takeover issues, the clamour for action has been much greater, with various steps advocated, under consideration or actually taken:-

— a 1990 Office of Technology Assessment report has suggested "adjusting the capital gains tax rate to favour long-term gains and penalize short-term asset turnover. Another option is to tax securities transactions, which would penalise those whose turnover is greatest". (28)

— leading US Senators have proposed an "Excessive Churning and Speculation Act" with an excise tax on short-term gains of pension funds (10 per cent on assets held less than 90 days, and 5 per cent on assets held for 90 to 180 days). (29)

— US Treasury Secretary Brady is reported, under the heading "Brady Blasts Pension Funds for Taking Short-Term View" (30), to have asserted that short-term trading strategies and similar practices "can't possibly contribute in an important way to performance, much less to national goals". The US Treasury is considering measures to encourage "both executives and institutional investors to think longer-term".

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— in the majority of US states there has been a recent spate of anti-takeover legislation.

(b) suggestions from City practitioners

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VI. PIVOTING THE PENSION FUNDS

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termism was a feature of all our lives and it was both good for their funds and good for companies by keeping them on their toes. Other funds managers were more concerned about short-termism, with responses all pointing towards more stability — longer performance periods, fewer changes in managers, more indexation, steps to encourage longer shareholdings, and differential tax treatment depending on share turnover. A damping down of take-over activity would also be beneficial. Other suggestions (from brokers) included different accounting treatment, eg more "capitalization" of R&D, or new financing techniques to enable R&D to be financed without affecting profits directly.

(c) **voluntary pivoting by the pension fund industry**

51. What appears to be required from the pension fund industry (at no apparent cost to the industry itself) is a significant reduction in damaging short-term pressures on companies, and a shift towards the supportive "German bank" type role heralded (prematurely) in the 1970s.

52. In theory at least it should be possible for the pension fund industry to introduce the following changes:-

(i) **longer periods for performance reviews**

— a shift from quarterly to six-monthly reviews and then possibly to annual reviews, could significantly reduce short-term pressures on fund managers; turnover of portfolios might fall considerably, and more emphasis be put on building up relationships with companies in support of their management goals;

(ii) **self-discipline through share turnover ceilings**

— the industry could agree appropriate turnover ceilings for fund managers, hopefully well below late 1980 levels; the consequent reduction in short-term pressures on companies might be considerable;

(iii) **more management-supportive attitudes in takeovers**

— ideally institutional shareholders should support the management, unless there is clear management failure, rather than accepting the financial premium offered by a bidder, given that the extra value represented by the premium still remains with the company (except in those cases where it reflects genuine strategic value from merging of industrial and commercial interests);

— the Chairman of the Stock Exchange was recently reported (32) as saying that company boards should try to forge a partnership with their main institutional investors; the article noted that "the argument had moved a long way", and logic pointed to non-executive directors representing the institutions; (a potentially valuable development but one that has taken so far over ten years to materialise, and may take much longer still; it was advocated as long ago as 1979). (33).

53. We are not optimistic, however, that the pension fund industry, or the institutions generally, would take such actions voluntarily. There is a diversity of views between internal and external managers within the pension fund industry. For a given company there may be a dozen or even more institutions with "important" shareholdings, and getting a coherent view on representation by non-executive directors in takeover situations, could be very difficult. There are other groups with vested interests in maintaining the (hyperactive) status quo, including brokers looking for turnover, merchant bankers looking for takeover possibilities, advisers to trustees, performance measurers, etc. The theoretical overseers (ie the trustees), appear as an elusive group, who come from over a thousand companies, public industries and local authorities. They cannot be addressed as a coherent group; even less so could they "oversee" the proposed changes in practices.

(d) **pivoting by changing the fiscal and takeover rules**

54. Given such doubts over the introduction of "voluntary" measures, consideration should be given to fiscal measures and to changes in takeover policy.

55. Fiscal solutions might provide the scope for tailoring the disincentives, or even incentives, to suit the objectives. Possible fiscal options might include:-

— a short-term capital gain tax or a short-term trading tax (eg 2% on any holding sold within 6 months of purchase), possibly coupled with

— bonuses for longer-term holdings (eg tax credits or bonuses for holdings over 3 or even 5 years)

56 . Changes in takeover practices, either voluntary changes through changes in the attitudes of key institutions, or, more realistically, through changes in the takeover rules, appear to be key steps in tackling "short-termism". Basically the main need appears to be for a more deliberate approach to takeovers and the avoidance of "fevers" of hostile takeovers.

57. In the words of US Treasury Secretary Brady, commenting on "a takeover movement so violent" that nobody could concentrate on long-term plans, "Those who thought they were improving the US's ability to compete internationally because of the takeover phenomenon, by putting in new management and increasing the efficiency of management, have produced the opposite result. They've added to the short-term preoccupation because they've got everyone looking over their shoulders to provide a quarterly increase in profits which has the effect of cutting-down long-term profits."(34).

58. Changes in takeover policy might include:-

— lowering of the 30% limit for making a full bid;

— more specifically, a requirement that the bidder should set out to shareholders the industrial and commercial advantages of the takeover, and how such advantages would be realised.

This latter requirement would have several advantages. It would make the bidder think long and hard over producing a strategy that would stand up to public inspection. It would enable the shareholders to take a full long-term view of their company's prospects, rather than looking at their holdings as gaming chips. It would retain the managerial discipline of the takeover threat, and also avoid any inconsistency with an overall merger policy based on competition.

59. Such changes in the rules would, however, have to be carefully examined for side effects, including effects on existing fiscal practices, on the deployment of funds by the UK investors between home and overseas, on London's role as a financial centre, on the UK stance in future EEC takeover policy, and on other relevant international developments. But the benefits from removing a "fundamental flaw in our economy" could be overwhelming.

VII SUMMARY OF CONCLUSIONS AND SUGGESTED ACTIONS

60. One leading City figure recently asked:— "For how long can we ignore the very positive performance of competitors whose systems are not driven by the need to produce short-term rewards for shareholders?" (35)

61. That question is at the heart of the issues we have discussed. Our survey suggests that:—

(a) the company/City interface has resulted in too high a priority for short-term profits and dividends at the expense of R&D and other innovative investment; and

(b) particular practices of key institutions have helped to sustain such priority for the short-term, with quarterly performance periods, high activity rates and the apparently equivocal attitudes to takeover bids of the external managers of pension funds, being at the forefront.

62. As the IAB's "Innovation and Growth" booklet suggests, UK managers need to devote more effort and resources to innovation. It is up to them to devise, present, and implement the innovation plans necessary to enable their companies to win at the technology frontiers and achieve profitable and sustainable growth.

63. Yet if those managers are to innovate successfully changes are needed on the company/City interface. These will involve companies and the institutions alike, and also the Government. We suggest concerted actions by all three groups, with advances on two fronts:—

More prominence for innovation plans

(i) **publication of an R&D company scoreboard**

— with comparisons between R&D activity of individual UK companies, and international comparisons as far as possible;

(ii) **better company presentations**

— with specific guidance on the presentation of innovation plans, and, in particular, on step-changes in innovative activity;

(iii) **more analysts capable of assessing such plans**

— with technology-aware analysts in all sectors, thereby avoiding company managers becoming frustrated and ultimately inhibited over their failure to communicate their objectives;

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— with technology-aware analysts in all sectors, thereby avoiding company managers becoming frustrated and ultimately inhibited over their failure to communicate their objectives.

(iv) **plans to be discussed at company/institution meetings**

— between two "informed" sides, with managers being judged by how convincing they are in explaining the prospective returns from their innovation plans.

Pivoting the pension funds

v **voluntary pivoting by the pension fund Industry —**

— longer periods for performance reviews

— self-discipline through share turnover ceilings

— more management-supportive attitudes in takeover situations;

(vi) **pivoting by changing the rules**

— fiscal steps (carrots as well as sticks) to encourage longer-term shareholdings;

— modifications in takeover policy to encourage shareholders to look at the industrial and commercial advantages, and to avoid takeover fevers.

64. We hope these issues will be debated at the "Innovation and Short-Termism" Conference on 25 June 1990 and that appropriate follow-up action will follow.

JOHN CHAPMAN
MARTIN SHELLEY
Secretariat, Innovation Advisory Board

The UK's Performance on R&D Spend

(£m — constant 1985 prices)

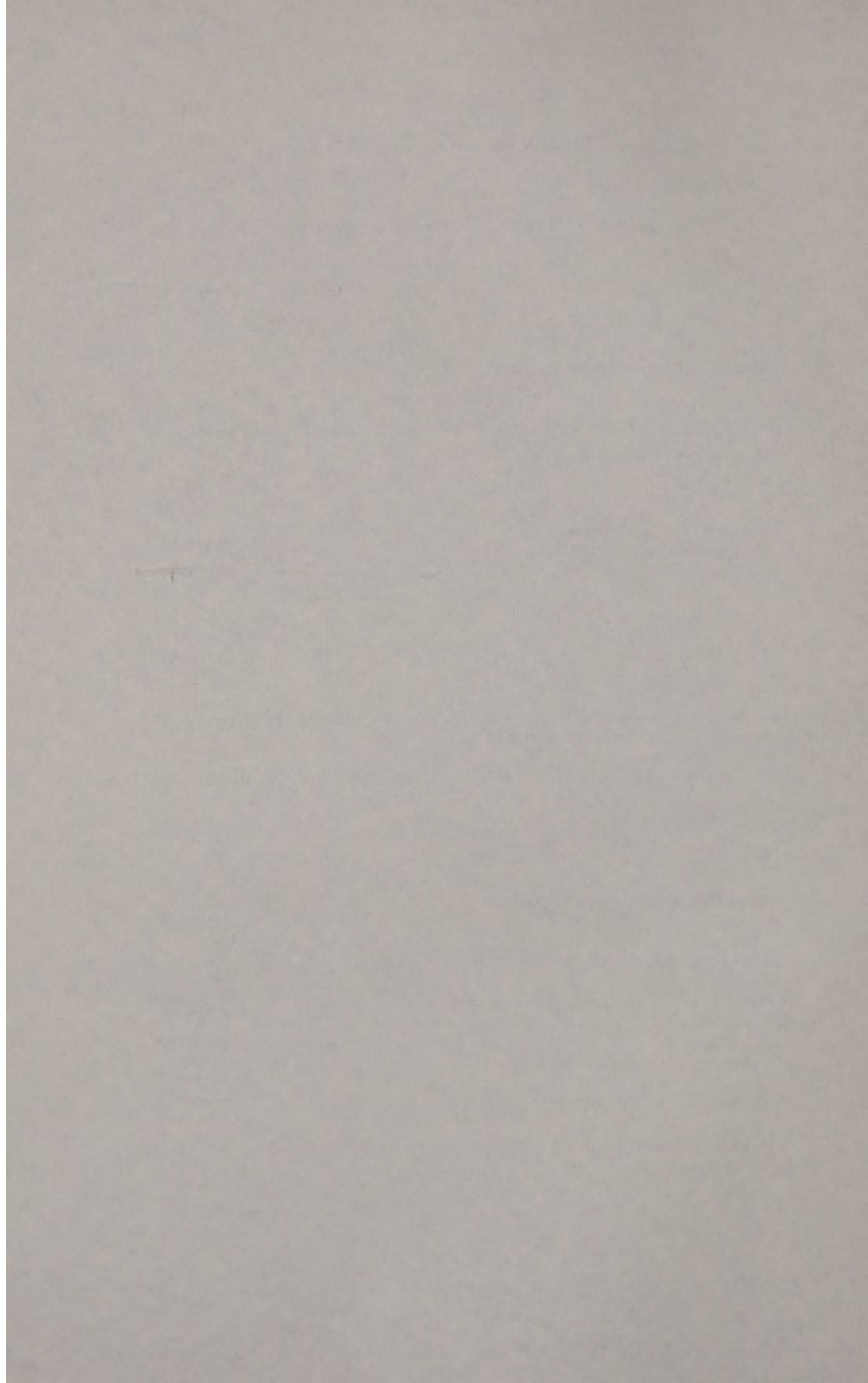
A — INTERNATIONAL COMPARISONS

		1975	1987	% Annual increases 1975-1987
(i)	**Total Civil Expenditure on R&D**			
	UK	4881	6659	2.6
	France	4324	6846	3.9
	Germany	7113	11974	4.4
	Japan	10460	26090	7.9
	USA	27615	44915	4.1
(ii)	**Industry funded Business Enterprise R&D**			
	UK	2342	3957*	4.5(3.6)*
	France	1953	3560	5.1
	Germany	3766	8064	6.6
	Japan	5858	17034	9.3
	USA	16178	30448	5.4

(* UK totals are swollen by the inclusion of UKAEA from 1986; adjustment to exclude UKAEA gives a 3.6% annual growth figure).

B — SECTORAL ANALYSIS OF RECENT UK INCREASES

	1985	1988	% Annual increase 1985-1988
Total Business Enterprise R&D			
Chemicals	942	1362	13.1
Mechanical Engineering	263	261	- 0.3
Electronics	1759	1787	0.5
Other electrical engineering	126	127	0.3
Motor vehicles	372	405	2.9
Aerospace	818	705	- 4.8
Other manufactured products	395	427	2.6
All manufactured products	4673	5084	2.8
(All manufactured products without chemicals)	3731	3722	- 0.1



THE UK's COMPARATIVE RELIANCE ON INSTITUTIONAL SHAREHOLDERS

Percentage Distribution of Shareholdings

	Households	Companies	PFs and ICs	Banks and OFIs	State	Foreigners
UK	17	12	49	15	3	4
West Germany	17	36	7	9	7	24
USA	66	—	25	4	—	5
Japan	23	29	16	24	1	7

Notes

(1) PFs and ICs are "Pension Funds and Insurance Companies"

(ii) The above figures relate to end 1985. Since then the proportion of shares in institutional hands has risen in the UK to 70% (of which pension funds account for over half).

(iii) The figures understate the influence of the banks in Germany, and the firmness of company cross-holdings in Germany.

(Source: Bank of England, March 1989)

ANNEX C

PENSION FUND MANAGERS — ACTIVITY LEVELS AND RETURNS

A — ACTIVITY

Type of Manager	1986	1987	1988	1989	Number	Funds managed (end 1989) (Value (£bn)
Internal	37	43	33	48	70	65
Part internal/external	58	104	64	84	75	75
2 or more managers	85	93	98	106	79	9
Financial conglomerates	82	78	65	84	858	53
Life company managed	74	94	60	57	7	7
Life company segregated	57	70	67	69	111	12
Independent managers	117	134	87	111	352	12
WM Universe	56	80	58	77	1552	234

B — RETURNS (%)

Type of Manager	1986	1987	1988	1989	4 year annualised
Internal	26.9	6.5	10.9	36.5	19.6
Part internal/external	25.3	7.1	10.5	35.9	19.1
2 or more managers	24.8	7.3	8.7	34.7	18.3
Financial conglomerates	25.7	7.3	10.6	36.2	19.4
Life company managed	25.8	8.2	9.1	37.6	19.6
Life company segregated	26.8	7.4	9.5	34.1	18.9
Independent managers	25.1	7.3	8.2	35.4	18.4
WM Universe	25.9	7.1	10.4	36.0	19.3
FT All Shares Index	27.4	8.0	11.5	36.1	20.2

Note — "Financial conglomerates" is a term covering bodies such as merchant banks with activities other than fund management.

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