Long-Term Investing

A proposal for how to define and implement long-term investing

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Many voices have been raised in recent years extolling the virtues of long-term investing, and condemning the short-termism in today's stock markets. Pillars of our financial and business community—including CFA Institute, the Business Roundtable, the Conference Board, the United Nations, the World Economic Forum, and the Aspen Institute—have all prescribed the long term as a cure for our short-term ills.

An excessive focus on short-term profits has various detrimental effects. It causes corporate managers to misallocate assets. It introduces dangerous volatility into financial markets. It means society must divert productive resources to repairing environmental and social damage done in the headlong pursuit of profits.

Indexers behave as though stock price and value of corporations are one and the same.

In a 2006 report, the Conference Board speaks for many when it describes the dangers of the short term:

> *On a macro-economic level, short-term visions are the cause for market volatility and the instability of financial institutions. From the micro-economic standpoint, they undermine management continuity and expose a public company to the risk of losing sight of its strategic business model, compromising its competitiveness. In addition, the pressure to meet short-term numbers may induce senior managers to externalize a number of business costs (i.e., the cost of a state-of-the-art pollution system), often to the detriment of the environment and future generations.*[1]

There are a host of useful remedies for the excessively short-term outlooks of the financial and corporate communities. These include:

- Reforming the reporting of quarterly corporate earnings and the compensation incentives of analysts and managers.
- Broadening fiduciary duties.
- Including social, environmental, and corporate governance issues into stock analysis and institutional investors' mandates.
- Increasing non-financial disclosure.
- Creating best-practice guidelines for pension funds.
- Revitalizing education on the virtues of the long-term approach.

Despite widespread concern, little real change is taking place. Financial professionals are aware of the trap in which they are caught. They can see ways out of it. But they are unable to act in ways that substantively change their practices. As Alain Leclair, president of the French Association of Financial Management has put it: "We…face a dilemma. In practically all aspects [of investing], although everything ought to direct us to adopt a long-term approach, we are forced to measure and act in the short term."[2]

We might call this the Short-Term Measurement Dilemma. It goes to the heart of why long-term investing is currently so difficult to implement.
When the market is valued according to a short-term measurement—that is, stock prices—and when managers' performance is measured against these prices, then long-term investing becomes impossible.

In particular, the liquidity, or ease of trading, in today's stock markets contributes to the short-term perspective. Stock market prices are measured daily, hourly, and by the minute. A market that offers participants instantaneous opportunities to measure and act on their price-based worth—that allows them to jump in and out of stocks at little cost on the slightest bit of news or slimmest of rumors—deprives them of a perspective from which to measure the value of the companies over years or decades.[3]

Investors and corporate managers clearly can see the detrimental effects of this short-term perspective. What they cannot see, and what is keeping them from change, is a clear definition of an alternative long-term investing system and a system for implementing it. Without these two things in hand, real change will be impossible.

All the pieces for solving this puzzle are already on the table. Yet the change that is implied by a shift to the long term involves a new way of thinking for a financial community of tremendous size and power. Change inevitably will meet with resistance.

This paper proposes a simple, clear definition of long-term investing and explores its practical implications. This should bring new approaches to the financial world which will create true value and avoid the pitfalls of short-term price speculation. Although this paper does not deal with the similar problem of short-termism for managers in the corporate world, the dilemma and its possible solutions run parallel to those suggested here.[4]

A Definition of Long-term Investing

A comprehensive definition of long-term investing must address three issues:

1) the benefits of holding stocks for long periods of time;
2) the incorporation of environmental, social and corporate governance (ESG) factors into investing; and
3) the willingness to add value to investments.

The definition of long-term investing proposed here incorporates these three elements. It is as follows:

Long-term investors speculate on the value of corporations to society and the environment, while simultaneously seeking to enhance that value at the company, industry, and societal level.

This definition is intended to steer investors clear of the detrimental focus on price, and emphasize value. It works because the wealth corporations create is more than stock price. It corrects the conception that investors can function only as price takers, not value makers. It stresses that, like investors in other asset classes, stock investors have the capability—and the responsibility—to add to the social and environmental, as well as the financial, value of their investments. To do so, long-term investors in the stock markets must engage management on important social and environmental issues and set clear standards—that go beyond relative price—on how to allocate their investments.

We'll look at the three components of our definition, one at a time.

The Value of Long Holding Periods

Much of the despair about short-termism focuses on day traders, arbitrageurs, profit maximizers, and others who think the road to fortune lies in moving quickly in and out of stocks. As the Conference Board noted, the 40-plus participants in its summit on short-termism were unanimous on this point "stock investment speculation is a major cause of short-termism."

If speculation on price is the cause of the disease, why shouldn't a simple remedy—buying and holding stock for long periods of time—be the cure?

For many in the investment world, "buy long and hold long" is a sufficient definition of the long term. However, this definition does not go far enough.

Indisputably, holding stocks for longer periods of time can bring investors great financial benefit. Long holding periods reduce transaction costs and save on tax liabilities. But simply buying and holding for a longer period is not enough to create a stock market where a long-term view and speculation on value predominate. Two widely practiced, but somewhat contradictory, buy-and-hold strategies in today's markets demonstrate why this is true.

- **Index investing** involves buying a broadly diversified basket of stocks and holding them for long periods of time. Its underlying assumption is that you cannot beat the market.

- **Value investing** involves selecting individual stocks that the market has not correctly priced and holding them for long periods. Its underlying assumption is that you can beat the market.

Neither captures the essence of the long term firmly enough to escape from the short term of our current marketplace. A closer look at index investing confirms this point.

Index investing is one of the most widely practiced investment techniques in the stock market today. It consists of buying diversified baskets of stocks and holding them more or less forever. Common benchmarks in which indexers invest are the Standard & Poor's 500 and the Russell 1000 indexes. These two indexes consist of the largest publicly traded stocks in the United States as measured by price. Literally thousands of other indexes capture various other markets and market segments around the world. Institutional investors today have invested trillions of dollars in these index funds.

Stock indexes are usually capitalization weighted—that is, the size of the holdings of each stock in the index is determined by its market price multiplied by its number of shares outstanding. Because index investors hold stocks for an essentially unlimited time, it seems logical to consider them the embodiment of long-term investing. Indeed, many pension funds that use indexing strategies consider themselves long-term investors.

However, simply holding stock for a long time does not guarantee that one is free from short-termism. As Simon Zadek has observed: "When pension funds say they are long-term investors, what they mean is that they have rolling investments in largely indexed linked funds. To speak accurately this makes them *perpetual investors* making short-term investments, forever."[5]

Or more accurately, indexers are exactly as short term or as long term as the stock market is at any given moment. When indexers buy and sell stock, they do so at whatever the market price is that day, without attempting to determine if these stocks are overvalued or undervalued. They therefore reflect, and indeed amplify, any pricing irrationalities of the markets at any given time. If there is a speculative bubble, if stocks are wildly overvalued or undervalued, indexers participate in that irrational exuberance or despair to exactly the extent of other market participants.

Professor Alfred Rappaport goes to the heart of the problem of index investing when he notes that "Index funds make no independent contribution to allocatively efficient prices because indexing requires no valuations."[6] Indexers make no attempt to determine the value of the stocks they are purchasing because they believe that stock price and the value of corporations are one and the same. Their most fundamental belief is that investors cannot beat the market by making educated guesses about when stock price deviates from underlying value. They just buy the market. Indeed, the only way for indexers to add value to their portfolios is to reduce transaction costs.

By abandoning any attempt to actively value the market, indexers make it more speculative in two ways. First, they increase the percentage of speculators in the marketplace by withdrawing themselves and others who might potentially be interested in long-term valuation from the setting of stock prices, leaving that role to short-term speculators. Second, they force even those managers left in the market who are attempting to value stocks with a view toward the long term into mimicking whatever prices may be set by the short-term speculators. As one fund manager and participant in the World Economic Forum's working group explained, "As long as client [e.g., pension fund trustees] mandates require us to deliver performance benchmarked against short-term market tracker indexes, we will of course remain short term in our outlook."[7]

If we want stock markets to assess the long-term value of corporations, index investors will be of no help. We must look elsewhere. One place is to the value investor. Value investors are long term in their perspective and help counteract the short-termism of today's markets. They are stock pickers who evaluate the underlying, intrinsic value of a company, which they usually define as its long-term earnings potential, and compare that to today's stock price. Because earnings potential over the long term is their measure of value, value investors usually buy and hold. Put differently, because the markets can take a long time to come around to value investors' point of view, they tend to hold for long periods of time. Warren Buffett, the chief executive of Berkshire Hathaway and a widely recognized long-term investor, has reportedly asserted that his favorite holding period is "forever."[8]

Robert A. G. Monks offers an example of relationship investing, using one's influence to improve the corporate governance of firms.

The great virtue of value investors is that they are willing to take an alternative view of the intrinsic value of a corporation to that of the short-term markets. They sell when they think stocks are overpriced and buy when they believe they are undervalued. They can counterbalance the wild swings of markets that are purely speculative—markets that overshoot because investors become irrationally optimistic or pessimistic about what companies are worth. If long-term investors can predominate in the market, they can send signals to managers about which corporations are allocating their funds in an economically productive way and which are not. It is therefore crucial, as Keynes has wisely observed, that those with a long term predominate in the marketplace.[9]

If this function of the long term in the marketplace is so important, why isn't the market set up so that value investors can predominate? One might think that value investors would be rewarded for their diligence and the wisdom of their approach, that they would consistently turn in superior performance results to their irrationally speculative peers, and that institutional investors would rush to place their funds in the hands of such wise and productive managers. The answer is both paradoxical and discouraging. Value investors in the aggregate cannot, *by definition,* turn in better price-based performance results than the indexers over long periods of time. Although a select few active managers may be able to beat the markets consistently, institutional investors find it difficult to justify making substantial use of them as a whole. Index investors derive great satisfaction in pointing out that if value investors' returns are measured against the performance of capitalization-weight benchmark indexes, on average and over the long-haul they cannot "beat the market." For this reason, indexers assert that value investors do not add value. This is devastating for advocates of long-term investing. It is also the reason that the Short-Term Measurement Dilemma is real and difficult to resolve. This dilemma for value investors arises because, although some value investors will always beat the index benchmarks, it is impossible to beat price-based market averages all the time. Two considerations make this inevitable. First, it is logically absurd to imagine a market where some managers outperform all the time and others underperform all the time. No intelligent investor would stay forever with a manager who underperforms all the time. Underperforming managers will either lose their clients and go out of business or change their tactics. Once managers' performance is measured against market prices set by counterbalancing buyers and sellers, by definition, half will outperform and half will underperform over time.

Second, value managers must incur an extra cost that index investors do not pay. That cost is research. This means that indexers have a cost advantage in the marketplace that will cause them to outperform over time and on average. Value investors, each trying to beat the performance of the others, must actually research the companies in which they invest. As hard as it is to believe, indexers do no research at all. Without this expense, index investors on average and over the long haul inevitably outperform the active value managers. Indexers, by definition, will outperform those who set the prices because they don't have to bear the cost of the research necessary to set the prices.

As John Bogle, the founder of the Vanguard mutual fund company and a fierce advocate of index investing, has succinctly put it, "For all investors as a group, then, beating the market *before* costs is a zero-sum game; beating the market *after* costs is a loser's game" (emphasis in original).[10] In other words, the market is a zero-sum game: some participants gain at the expense of others, with none adding any true value. In such a market, those who incur costs by trying to determine the value of companies will inevitably underperform those without these costs.[11]

Keynes, an advocate of the long-term approach to investing, was despairingly articulate on this point:

Investment based on genuine long-term expectation is so difficult to-day as to be scarcely practicable. He who attempts it must surely lead much more laborious days and run greater risks than he who tries to guess better than the crowd how the crowd will behave; and, given equal intelligence, he may make more disastrous mistakes. There is no clear evidence from experience that the investment policy which is socially advantageous coincides with that which is most profitable.[12]

The long-term value investors about whom Keynes is speaking will always find themselves at a competitive disadvantage in today's stock markets and never predominate as long as their performance is measured against stock price.

Long-term value investors cannot escape from the price-based measurement trap because it is price, as related to long-term earnings potential, by which they still judge their own performance. Their investment time horizon may be "forever"—or Judgment Day, another horizon line by which Buffett likes to calculate the earnings power of corporations—but price is still the ultimate measurement of returns.[13]

Thus, the Short-Term Measurement Dilemma cannot be resolved by simply looking to long-term earnings potential. Other factors must be introduced if we are to give the long term a deeper meaning and more influence in our markets today.

The Materiality of Social and Environmental Factors

In determining the value of corporations, it is vital for long-term investors to consider factors other than price and earnings. Environmental, social, and governance (ESG) factors inherently impose a longer-term perspective. They take into account issues well-suited to a long-term perspective, and these issues often cannot be clearly tied back to price. Any definition of the full potential of long-term investing must incorporate these factors.

ESG-based evaluations of companies reach beyond those from traditional stock analysts because they encompass the less tangible aspects of a company's value. Generally, ESG factors relate to a company's relations with its stakeholders such as employees, customers, communities, suppliers, and the environment. Specifically, they include issues such as workplace safety, employee training, product quality, charitable giving, vendor labor standards, carbon emissions, and pollution prevention. These factors can lead to the exclusion of particular companies from investment consideration when they fail to meet certain stakeholder-specific standards. In addition, ESG considerations can help evaluate the role of whole industries in a sustainable society. Involvement in the production of weapons of mass destruction or tobacco, for example, might lead to exclusion.

Some ESG factors can be directly related to a company's stock price and some cannot. Those that can be tied to stock price are usually referred to as financially "material." Those that cannot are sometimes referred to as factors that have "non-financial materiality."[14]

Another way of describing these non-financially material ESG factors is to use the economists' conception of positive or negative externalities, describing them as factors that create costs or benefits that cannot be translated easily into market price. However they are described and whatever their relationship to materiality, ESG factors are inherently long-term in nature and contribute to the definition of long-term investing.[15]

ESG factors help direct the market to the long term because they frequently focus on issues where risks and rewards are best measured in years and decades, not months and quarters. Environmental issues with such long-term horizons include climate change, ozone-depletion caused by industrial chemicals, development of alternative energy sources, changes in environmental regulation, environmental life-cycle analysis for products, energy efficiency, and the effective implementation of company-wide environmental management systems. Social issues with similarly long horizons include the availability of clean water in the coming century, the adequacy of labor standards at suppliers in developing nations, the incorporation of women and ethnic minorities into corporate workforces, the balancing of the pressures of the workplace and the demands of family life, investments in a highly trained workforce, and support for community economic development.

If stock price appreciation is the only goal of relationship investing, investors are back in the trap of short-termism.

A growing number of investors state clearly that they consider ESG factors as relevant to their investments and corporate valuation. For example, Asset Management Working Group in 2004 reported that at the nine major brokerage houses that they commissioned for analyses of the role of ESG factors in stock valuations, "Analysts agreed that environmental, social, and corporate governance criteria impact both positively and negatively on long-term shareholder value."[16].

In an encouraging development along similar lines, a number of major investment houses increasingly are hiring in-house staff to promote the integration of ESG research into their analyses for the mainstream investment community. For example:

- **Citigroup.** This firm's Smith Barney office in London has a team of analysts dedicated to publishing research on "sustainable investable themes." In 2005, this team's report, *Crossing the River,* documented its approach to finding "bridges" which it envisions as stepping-stones in a river between environmental and financial performance.

- **Societé Générale.** This French investment bank has a five-member research team at its Paris headquarters that follows sustainability issues, track their financial implications, and integrates this research into stock analyses.

These investors and analysts are incorporating ESG factors because they believe doing so will make them better stock pickers in the long run. In this sense they are like value investors, looking for buying and selling opportunities when ESG factors show that a company's intrinsic value has deviated from its current price.

It should be noted that simply because ESG factors look to the long term, they do not automatically protect the stock markets from short-term price speculation. In fact, the more ESG factors become incorporated into current price/earnings models, the more likely they are to fall prey to the short-term speculation those models produce. This is true because highly liquid markets invite speculation when price is the only consideration.

Take, for example, the investment opportunities offered by the development of alternative energy sources. The exact prospects for wind-power companies are unknown today, but that doesn't keep the markets from speculating on them and driving their stock prices up sharply. In France in early 2007, for example, strong performance of wind power and other green stocks prompted a *Le Monde* story headlined "Is There a Green Stock Bubble?" [17]

While some ESG factors clearly are related to stock price, other ESG factors clearly cannot be related to the price of individual stocks or the market valuation of whole industries. This type of factor can be described as non-financially material or as an externality.

Externalities are costs (or gains) that are borne (or shared) by those not involved in a particular transaction. In other words, externalities are costs and benefits that are not captured in the marketplace and cannot be measured by price. An example of a negative externality would be the health damage that tobacco products cause, costs that are borne by society. A positive externality would be the cost of training employees in skills that they could then take elsewhere.

Ironically, considerations of externalities can, in theory, lead to investing in companies that cause harm and to shunning companies that produce societal benefit. Jeremy Siegel reports that the best performing U.S. stock of the past 75 years has been Philip Morris (now Altria).[18] Furthermore, Siegel argues that investors are not rewarded for investments in companies that enhance productivity in the economy.

Once a factor that has been an externality—carbon emissions, for example—becomes priceable in the markets, it will no longer be an externality. As long as price is the measure of stock value, markets cannot account for externalities. This is simply a restatement of one of the most painful aspects of the Short-Term Measurement Dilemma.

However, if investors make their primary concern the economy as a whole, not the price performance of a single stock or industry, many of the complications of factoring in externalities disappear.

This is the argument for the concept of universal investing, initially propounded by Robert A.G. Monks and Nell Minnow, and subsequently elaborated by Professors James Hawley and Andrew Williams.[19] Universal investors can be defined as pension funds or other institutional investors so large that they are invested across all asset classes. Universal investors essentially "own the economy." It does not profit them to invest in a company that increases earnings by externalizing environmental or other social costs onto other companies or the economy. The company's earnings may rise, but that gain will be offset by losses at other firms that will affect the investor's portfolio. As Hawley and Williams put it:

For a universal owner, and thus for its beneficiaries, the whole may well be greater than the sum of its parts since long-term profit maximization for the portfolio of a universal owner involves enhancing not just return on a firm-by-firm basis, but enhancing productivity in the economy as a whole. This approach to the role and responsibility of universal ownership simply takes two basic ideas, externalities and portfolio theory…and combines them.[20]

By factoring in ESG externalities, long-term investors remain aware of the effects of their investments on the economy as a whole. Being able to factor these externalities into assessments of positive and negative effects on the environment and society depends, of course, on the availability of data. Progress on disclosure of this data is being made by the groundbreaking work of such organizations as the Global Reporting Initiative and the United Nations Global Compact. Progress on the analysis of this data is being pioneered by research firms such as Trucost who are figuring out how to measure potential long-term costs.

Investors who factor in both financially and non-financially material ESG factors can be said to be long-term investors. Those who only factor in financially material, price-related ESG factors will not, however, entirely escape from the traps laid by price-based performance measurements. Those who factor in the non-financially material externalities will need to take one additional step to act like a long-term investor in the deepest sense. That step is to "add value" to their investments by actively discouraging negative externalities and encouraging positive ones.

Adding Value to Investments as the Key to the Long Term

The final piece of the puzzle of defining long-term investing is about investors using ESG factors as a tool to add value to the companies in which they are investing. This value can be reflected in many different ways. It may show up in short-term stock price appreciation, long-term price appreciation, the creation of intangible company assets, the enhancement of reputation, increased prosperity for local or national economies, enhanced trust between corporations and society, a healthier and more sustainable environment, or many other benefits for society and the environment.

It is this willingness to include value enhancement as a legitimate part of the investment process that allows long-term investors to escape from the dictates of price-based benchmarks. Value can be added at the industry, societal, or environmental levels by minimizing negative externalities (avoiding companies or industries with ESG risks), or by maximizing positive externalities (emphasizing companies or industries that make long-term investments in their stakeholders).

Adding to the value of investments is not a radical idea. In certain asset classes other than equities, investors are expected to add value. Venture capital investors and private equity managers, for example, actively manage the firms in which they invest, placing representatives on boards of directors, hiring and firing top managers, or making strategic management decisions. Similarly, real estate investors frequently invest in the properties they own to enhance their value in the marketplace.

The stock market, however—because of its liquidity and because investors are separated from the managers of the corporations in which they invest—does not lend itself easily to value creation by investors. That is not to say that such value creation is impossible. When Solomon Brothers was embroiled in a major scandal involving illegal trading in the bond market, Warren Buffett as a major long-term investor agreed to take a seat on the company's board to help restore confidence. But Buffett is not likely to argue that this is a model that should be widely replicated.A more widely accepted example of value creation by investors is that of relationship investing. An example is the work of Robert A.G. Monks through LENS Investment Management (now LENS Governance Advisors) and Ralph Whitworth through Relational Investors LLC. Such relationship investors take substantial stakes in companies they believe have performed poorly and use their influence to improve the corporate governance of these firms.

Social investors are not aiming to create long-term value on their own, but in conjunction with other players in society.

More generally, institutional investors such as public and union pension funds have in the past 15 years increasingly sought to add value to their investments by urging changes in corporate governance. For example, the Council of Institutional Investors each year creates a "Focus List" of companies whose poor financial performance can be helped by governance pressure from its members. A similar list is maintained by the California Public Employees Retirement System (CalPERS).

Relationship investors say their strategy pays off financially. From 1992 through 2000, when it closed shop as a money management firm, LENS' portfolio outperformed the Standard & Poor's 500 Index.[21] Similarly, Brad Barber, in his 2006 study of the activism program of CalPERS, says that CalPERS imprecisely estimates the wealth creation from its shareholder activism to be $3.1 billion between 1992 and 2005.[22]

However, if stock price appreciation is the only goal of relationship investing, investors are back in the trap of short-termism. They're no different from those they often criticize, the hedge funds and private equity firms that seek to add short-term value to their investments through cost cutting. These are the venture capitalists that German government officials described as "locusts" and whose managers are portrayed in the press as heartless, short-term profiteers.

What distinguishes the value created by relationship investors such as LENS and CalPERS is that they add value, not only to their particular investments but to the stock markets in general, by raising the standards of corporate governance. They often seek to create models of best practice and to create more honest and transparent financial markets.

This form of engagement with corporate management has its parallels on the environmental and social sides. Socially responsible investors with a long-term view seek to better the management of firms in part to improve their financial performance, but also to create models of best practice that can be replicated and bring broad societal benefit. They are creating positive externalities from which other investors and society may benefit.

These externalities can be created either through engagement with companies on ESG issues or by setting ESG standards for investment selection. These two tools function somewhat differently, but both can add value at the corporate, industry, and societal level.

Engagement on ESG issues follows the pattern of engagement by activist relationship investors. By engaging on issues such as carbon emissions, vendor standards, and equal opportunity employment, long-term investors seek to add value not only to a particular company's operations but to those of its industry as a whole.

This engagement can take the form of private dialogue with corporations, or more public confrontations. At the company level, for example, Domini Social Investments joined with other investors and non-profit organizations to successfully pressure Procter & Gamble to introduce a line of fair-trade coffee, a dialogue that ultimately resulted in the launch of P&G's Millstone line of fair-trade coffees.

On an industry level, a coalition of responsible investors representing trillions of dollars in assets has come together under the aegis of the Carbon Disclosure Project to urge emissions disclosures by the largest corporations in the world. A similar coalition has formed under the banner of the Extractive Industries Transparency Initiative, to urge companies to disclose payments to governments, particularly in the developing world. In the U.S., the Investors' Network on Climate Risk is a coalition of institutional investors working with U.S. energy companies and utilities.

In the United Kingdom, engagement is now a widespread practice among large money management companies committed to sustainability. Among the major firms committed to substantial engagement programs are Insight Investment (part of HBOS) and Morley Fund Management (Aviva). These firms communicate with hundreds of companies on dozens of social and environmental issues each year. F&C Asset Management—one of the earliest and most thorough proponents of engagement—offers a separate investment management product called "responsible engagement overlay," or "reo." Through this service, F&C will engage corporate managers on sustainability issues, whether or not F&C actually manages the client's funds. In 2006, F&C recorded 268 milestones, or instances in which "a company improves its policies, procedures, or performance following engagement by F&C's Governance and Sustainable Investment (GSI) team."[23]

For long-term investors, a stock can be seen as worthless at any price.

A second means of adding value is standard setting. Whereas mainstream investors will purchase any stock if the price is right, long-term investors let consideration of ESG factors limit or focus the number of companies in their investment universe. These investors can limit their universe, for example by eliminating industries such as tobacco and nuclear weapons that externalize costs onto society. In addition, they can seek to add value by shunning companies that do not meet internationally recognized labor standards or whose sustainability practices are sub-par. They also can focus their investments on companies that address emerging ESG issues such as alternative power generation, access to water, health, or sustainable agriculture.

The most dramatic example of how standard setting by investors can add unquantifiable value to society was that of the South Africa divestment movement of the 1980s and early 1990s. At that time, institutional investors around the world joined in a broad campaign to help dismantle the apartheid legal system in South Africa. This standard setting and divestment movement by institutional investors was made possible by the Sullivan Principles, devised to assess the quality of labor practices in that country. These principles served as the basis for exclusion of companies by investors when firms failed to meet levels of acceptable performance. The long-term goal of these standards, however, was not improved financial performance. The goal was the creation of a just society.

The Sullivan Principles have been a positive model for an ever-expanding series of standards and principles. The Ceres Principles were launched in the late 1980s explicitly to do for environmental issues in the U.S. what the Sullivan Principles had done for labor practices in South Africa. More recently, labor standards for specific industries as diverse as apparel, toys, cocoa, and rugs have been widely promulgated. Environmental standards and best ESG practices have been developed for the mining, construction, and banking industries.

Long-term investors broadly defined use of these standards to help assess the value of companies and base their investment decisions in part on these assessments. In doing so, these investors are not only seeking to identify companies with superior prospects for long-term financial performance. They also are seeking to achieve three additional goals:

1) avoid companies that pose long-term ESG risks to society;
2) help create positive externalities that benefit society; and
3) take a constructive part in a broad societal debate about the relationship between corporations and society.

When KLD's Domini 400 Index or the FTSE4Good Global Index series exclude manufacturers of nuclear weapons from their investable universe, they are not only avoiding companies with long-term ESG risks, but also are weighing in on the question of negative externalities. This question is not one that markets can resolve, nor is it the intention of these indexes to solve these problems. Instead, their exclusion policy is an implicit recognition that international governmental initiatives are needed to address negative externalities.

Social investors' efforts take place within the context of broader movements for change. They are not aiming to create long-term value on their own, but in conjunction with other players in society.

A desire to add value to investments in the public equity markets cannot be accounted for by current theories of investment management. It is beyond the scope of this paper to discuss the relationship between Modern Portfolio Theory (MPT) and a fully developed theory of long-term investing. However, it can be observed here that MPT addresses issues of holding period (longer is more efficient because you cannot beat the market by active trading) and ESG factors (matters of personal taste should not be factored into purely financial investment decisions). MPT is essentially silent on the issue of whether investors in the stock market can add value to their investments.

In addition, the value created by long-term investing as defined here contrasts sharply with the value that either short-term speculators or classical long-term value investors create. Short-term speculators arbitrage away short-term anomalies in the market. Long-term value investors minimize transaction costs, save on taxes, and capitalize on long-term market anomalies. The latter in particular can be said to reward corporations that are using their assets most efficiently to drive up earnings and hence stock price. Neither, however, addresses the question of externalities and the ability of investors to add value to their overall portfolio by minimizing the negative externalities and maximizing those that are positive.

Keith Ambachtscheer, a noted pension consultant, recently has suggested that the next step in the development of Modern Portfolio Theory might be the consideration of how investments can be used to create broad societal wealth. Ambachtscheer describes how investment can realize "the promise of a higher rate of societal wealth creation" as "the biggest prize of all."[24]

The implications of the broad definition of long-term investing envisioned here are substantial. This definition, although simple in form, implies three essential changes: a fundamentally different approach to assessing the value of companies; adopting active steps to increase the value of investments; and developing new means of measuring and managing ESG risks and rewards.

How Long-term Investing Affects Selection of Investments

Long-term investors will make active investment choices when they perceive that the value of companies or industries differs from that implied by today's price-driven markets.

In some regards, these investment decisions will resemble those made by traditional value investors. In two notable regards, however, they will differ. First, they will take ESG factors and externalities into account. Second, based on ESG factors, they will exclude individual companies and whole industries from their investment universes, regardless of cost. Consequently, from the perspective of the price-determined benchmarks that dominate today, they may appear more speculative and risky than traditional investors. This apparently increased level of risk arises both because the longer out investors look the more speculative they necessarily become, and because ESG factors call for a mixture of art and science in their evaluation.

These valuation techniques are a radical departure from today's mainstream. They imply a separation of price from value that can, under certain circumstances, be absolute. That is, for these long-term investors a stock can be seen as worthless at any price.

Augmentation of Value

Long-term investors seek to add value to their holdings in ways that are not solely related to price. These value-enhancing tactics include engagement and standard-setting practices such as one-on-one dialogues with management, participation in coalitions of investors addressing social or environmental issues, alliances with stockowners concerned about corporate governance, advocacy for the adoption of standards for social and environmental behavior, exclusion of companies from investment consideration, and participation in public policy discussion.

Value-creating stockowners look beyond questions of price to questions of just and sustainable societies.

This active approach to adding value is a radical departure from today's mainstream. Most investors in today's stock market believe their role is to reflect value, not to create it. Those that seek to create value do so solely by capitalizing on market or management inefficiencies, seizing mis-priced stocks or pressuring management to maximize short-term profits. Both approaches are essentially part of short-term, zero-sum games where no value need be added to society.

Long-term investors approach value creation as a more collaborative effort between corporations and society. Whether the issue is apartheid in South Africa, CEO compensation, energy conservation, or equal workplace opportunity, value-creating stockowners look beyond questions of price to questions of just and sustainable societies.

Measurement and Management of ESG Risks

Finally, long-term investing will depart radically from current investment practice in its measurement of risks and rewards. By seeking to minimize ESG risks and maximize positive externalities, long-term investors inevitably confront issues that markets have difficulty pricing. They cannot remain content to have their performance over the long term measured solely against price-based benchmarks. They must seek to assess value through other measurements.[25]

This involves the assessment of how in the long term companies can best add value to society. Such value can be difficult to measure in ways other than price, but that difficulty must be overcome if long-term investing is to become reality.

As Keynes wisely observed in *The General Theory of Employment Interest and Money*, it matters greatly whether the long term or the short term predominates in our financial markets.[26] This observation is no less true today than it was 70 years ago. If short-termers predominate, the social and environmental risks posed by corporations will go unmanaged. Given the size and power of our financial markets, and their increasing influence over the social and environmental quality of our lives, it is crucial that long-term strategies ultimately prevail.

To some, today's laser-like focus on price as a measure of value might make the dominance of the long term seem an unrealistic dream. Given the power and vested self-interests of those currently at the steering wheel, the prospects of turning this ship around seem dim.

Yet relatively simple changes in the definitions of what finance should do, and a clear vision of how to implement these changes, can alter the fundamental nature of the system. It starts by recognizing that the decision to equate value with price inevitably leads to short-termism. When we see this, the means to create a more value-based marketplace become more apparent. If we incorporate progress in financial risk management to increase value in the present, and build on growing understanding of the environmental and social factors that enhance our common future, we should be able in relatively short order to change the behavior of investors.

Finally, incorporating the long term into equity investing is only the start, not the end, of our journey. Similar approaches to the long term can be developed for other asset classes as well. Real estate, venture capital, private equity, cash, bonds, and commodities—all are subject to similar questions about the short and long term. The long term matters across all aspects of our financial activities. Progress in one asset class will support progress in all. Through this process, long-term investment can move from a goal devoutly wished for by some to a reality incorporated by all. ◙

FOOTNOTES

[1]Matteo Tonello, *Revisiting Stock-Market Short-Termism*. New York: The Conference Board, 2006. p.42.

[2] C. Gollier and A. Leclair, "Avant propos, pourquoi l'ISR a-t-il besoin de recherche universitaire? Regards croisés." *Revue D'Économie Financière No 8,* 2006. p.14.

[3] John Maynard Keynes, *General Theory of Employment, Interest and Money.* Amherst: Prometheus Books, 1997.

[4] John R. Graham, Campbell R. Harvey, and Shiva Rojgopal, *The Economic Implications of Corporate Financial Reporting.* NBER Working Paper No. 10550, June 2004.

[5] World Economic Forum, Global Corporate Citizenship Initiative, in cooperation with AccountAbility *Mainstreaming Responsible Investment.* January 2005, p.19.

[6] Alfred Rappaport, "The Economics of Short-term Performance Obsession," *Financial Analysts Journal,* Volume 61, No 3 May/June 2005, p.66.

[7] World Economic Forum 2005, op. cit.

[8]Jeremy J. Siegel, *The Future for Investors: Why the Tried and the True Triumph Over the Bold and the New.* New York: Crown Business, 2005, p.xi.

[9] Keynes 1997, op. cit.

[10] John C. Bogle, *The Battle for the Soul of Capitalism.* New Haven, CT: Yale University Press, 2005, p.159.

[11] As Peter Bernstein has pointed out, index investors do not actually believe that the market is a zero-sum game. They just act as if it is. They believe that the economy, like a rising tide, will benefit all players in the stock market. They believe in betting that the tide will rise, but not on betting that one ship will rise faster than another (Peter Bernstein, *Capital Ideas: The Improbable Origins of Modern Wall Street.* Hoboken: John Wiley & Sons, 2005, p. 120-121).

[12] Keynes 1997, op. cit.

[13] See the Berkshire Hathaway 2005 Annual Report, page 19.

[14] John Sabapathy (ed.), *Accountability Forum: Material Futures* "Editor's Note." Issue 11, Fall 2006, p.6.

[15] Space considerations preclude a full discussion of issues of materiality here. Many alternative definitions of the concept exist. For example, material information has been defined by the U.S. accounting profession as that which would affect the investment decisions of reasonable investors. In the United Kingdom, information is deemed material if it is relevant to considerations of a business' prospects for success. Alan Knight, the head of Standards and Related Services at AccountAbility, has described materiality as, among other things, encompassing "issues likely to be important now and in the future." Jed Emerson and Tim Little have argued that issues of materiality are often "subjective, based upon the particular goals of a given investor" (Emerson: 4). Whatever the definition, however, a distinction can be made between materiality that relates directly to stock price and materiality that is useful in broader valuations.

[16] UNEP Finance Initiative Asset Management Working Group. *The Materiality of Social, Environmental and Corporate Governance Issues to Equity Pricing:* 11 sector studies by brokerage house analysts at the request of the 2004 Report.

[17] Jérôme Porier, "Existe-t-il une bulle des valeurs vertes?" *Le Monde Argent* April 1-2, 2007: 2.

[18] Jeremy Sigel, *The Future for Investors: Why the Tried and the True Triumph over the Bold and the New,* New York: Crown Business, 2005.

[19] Robert A.G. Monks and Nell Minnow, *Watching the Watchers: Corporate Governance in the 21st Century.* Philadelphia: University of Pennsylvania Press, 2000. James P. Hawley and Andrew T. Williams, *The Rise of Fiduciary Capitalism: How Institutional Investors Can Make Corporate America More Democratic.* Philadelphia: University of Pennsylvania Press, 2000.

[20] Hawley and Williams 2000, op. cit.

[21] See LENS website at http://www.lens-inc.com.

[22] Brad M. Barber, *Monitoring the Monitor: Evaluating CalPERS Activism*. November 2006. Available at SSRN: http://ssrn.com/abstract=890321.

[23] F&C Asset Management, *2006 Corporate Responsibility Report,* page 6, available at http://www.fundworksinvestments.com/fn_filelibrary//File/co_gen_csr_annual_report_2006.pdf (last visited May 17, 2007).

[24] Keith Ambachtscheer, *Financial Analysts Journal,* January/February 2005, Vol 61 No. 1.

[25] Various alternatives to today's capitalization-weighted benchmark indexes exist. These include those weighted by financial factors other than price. Robert Arnott's fundamental indexes (Arnott) and Jeremy Siegel's indexes keyed to dividend payments (Siegel) are two such examples. Other examples including indexes such as those maintained by KLD Research & Analytics, Dow Jones and SAM Group, and FTSE4Good, use social and environmental criteria to limit the universe of stocks included in price-weighted indexes. These alternatives are steps in the right direction for those interested in long-term investing.

[26] Keynes 1997, op. cit.