Working Session 4: Long-term Investment Premium

In the working session on long-term investment premium, the panelists discuss various issues related to how investors can improve their returns by having a long-term horizon. Jean-Yves Gilet shared with us his investment experience as CEO of the FSI, and Paul Woolley gave very insightful analysis of current short-termism in the financial markets. Frederic Samama and Patrick Bolton presented their proposals on Capital Access Bond (CAB) and L-shares.

As the conference co-chair and moderator of this session, Professor **Patrick Bolton** from Columbia University presented his and Frederic Samama's proposal of a new kind of financial instrument to award long-term investors: Loyalty shares. He said there were different time horizons among different players, but average holding period for a stock on the NYSE has been decreasing from eight years to about one year over the past 40 years, and the UK and European investors' behaviors have also exhibited a similar trend. The market has recognized the lack of long-term investors. Professor Bolton cited the insufficient long-term incentives to properly align long-term goals of the company, managers and shareholders. Therefore, Professor Bolton and Mr. Samama propose a new kind of share called a loyalty share to award the long-term shareholders extra "loyalty compensation". When the investors purchase the loyalty shares, all shareholders are entitled to a "loyalty warrant", if the long-term shareholders have kept their shares for a given "loyalty period" (e.g. 2 years), the shareholders enjoy extra "loyalty compensation" in the form of a warrant, but if the shareholders have sold their shares within the loyalty period, they do not receive the extra payment. Loyalty shares' possible uses include rewarding costly monitoring, postponing a costly dividend, securing a strategic investor and facilitating a share issue.

Conference co-chair **Frederic Samama** of the Sovereign Wealth Funds Research Initiative presented his and Professor Bolton's work on Capital Access Bonds (CAB), a new form of contingent capital with an option to convert. The CAB is designed to allow corporate companies to secure a capital increase in advance, like a "commitment fee" with banks (access to the balance sheets with predetermined conditions), but on equity with investors. The CAB looks for a balance between investor's preferences, issuer's constraints and regulator's objectives.

SWFs/long-term investors are natural investors in the mechanism because it replicates the most successful private investor (Warren Buffett) investment strategy: risk acceptance in case of market fall and reward for this risk. Mr. Samama argued that what is true for Warren Buffett could be true for the other long term investors. It is even more true for state owned entities as principals support economies in distressed times. Moreover, as a tradable security, it allows liquidity and transparency.

Issuers' advantages from this financial instrument include that 1) the capital increase is secured in case of a downturn (with fixed parameters); 2) the decision is in their hands; and 3) reduced cost of capital. The government's interests include 1) transfer of risk to investors; 2) new market disciplines and 3) solution designed for a crisis situation: flexible, transparent and robust.

Jean-Yves Gilet, CEO of Fond Stratégique d'Investissement (FSI), talked about his experience as CEO of the FSI. Mr. Gilet said the FSI is a long term investor that was established during the financial crisis with a specific investment strategy. The FSI is an investment fund which: provides equity financing; is a

minority investor actively involved in corporate governance and management support; an investor which seeks opportunities for co-investments; a trustworthy public-sector investor; a long-term investor, with an investment horizon in line with industry cycles; and an investor that targets growing companies.

The FSI is a public investor with a specific roadmap. As a public investor, FSI has special investment pattern: It invests to foster companies' growth. Three quarters of the FSI's direct investments correspond to an injection of new money. There are three scenarios in which the FSI frequently invests: 1) to reinforce publicly-listed companies' shareholder structures, 2) to accompany corporate change, and 3) to foster corporate development. Following this roadmap, the FSI focuses on specific regions and sectors, small business growth, and socially responsible investment.

Mr. Gilet also discussed the positive externalities created by the FSI's countercyclical investment approach, and the details of the FSI's sector specific investments, such as in the automotive, timber, and biotech sectors.

Professor **Paul Woolley** from the London School of Economics presented on short-termism, and its private and social costs. He analyzed why short-termism is costly to investors and society alike, and then discussed how investors could implement a long-term strategy in response. He presented evidence of growing short-termism, including shorter holding periods and high share and manager turnover, and the explosion in high-frequency and derivatives trading. The explanation for short-termism includes contracts and guidelines with delegated managers, fee structures (especially performance fees), quarterly peer group comparisons, requirements to closely track indices, widespread use of momentum trading and mark-to-market valuations. Professor Woolley used momentum and fair value analysis to determine the private costs of short-termism. Finally, he argued that the social costs of short-termism include mispricing, bubbles and crashes.

Regarding how to implement long-term strategies, Professor Woolley made the following proposals: curtail momentum, cap turnover; reduce tracking requirements, especially of indices; use predominantly fair value as basis for investment; no performance fees or only long-run performance basis; limit use of derivatives for short-term risk purposes; set real benchmark like GDP; and finally, eliminate mark-to-market valuation constraints.