European Fund and Asset Management Association

EFAMA RESPONSE TO ESMA CONSULTATION ON SHORT-TERMISM

ANNEX

EFAMA appreciates the opportunity to provide feedback to the ESMA's survey on collection of evidence on undue short-term pressure from the financial sector on corporations. Nevertheless, we have several comments both of the approach taken, key aspects looked at, the process and the format of the questionnaire.

- **Short-termism is subjective and plays an important role in the markets**

As explained in our response to Q7, there are different sources of capital: public equity, private equity, venture capital, debt, private placements etc. Each type serves a different purpose and has its own specific, recommended holding period. What is long-term also depends on the needs and profile of end-investors.

It is difficult to distinguish between short-term and long-term investing. Market practice distinguishes day traders and high frequency traders, which can undoubtedly be considered short-term investors, from other investors. Using an analogy from money markets, a period up to 12 months can be considered short-term. In our view, this does not mean that there is anything wrong with such an investment horizon: such a horizon suits clients with comparable investment horizons and are alternatives to savings accounts in banks.

- **Buy-and-hold investing has to be mitigated with risk management measures.**

An asset manager is not simply focused on the maximization of expected return, but on doing so at an acceptable level of risk. The main risk is in the future: prediction of the future is difficult, and even more difficult in the long-term. Therefore, according to modern portfolio theory and its successor, post-modern portfolio theory, investment portfolios consist of a combination of different stocks (not perfectly positively correlated, leading to diversification and reduction of risk) which, although not all equally attractive when considered individually, together offer the maximum expected return for a given level of risk.

Asset managers always take into account the desired returns and risk profile of their clients. Risk management requires concessions to returns and therefore also investments to adjust risks instead of increase potential returns. This leads to a strategic asset allocation, which may have to be adapted temporarily according to market conditions. Such a temporary adjustment, called the tactical asset allocation, may not always be only 'defensive', in the sense that negative risks are avoided, but also positive to make the most of opportunities, where short-term gains are possible.

- **Definition of short-termism**

The definition that was in the EC mandate and was repeated in the questionnaire seems to be somewhat arbitrary and focusses too narrowly on shareholders. "The focus on short time horizons by both corporate managers and financial markets, prioritizing near-term shareholder interest over long-term growth of the firm". Academic literature defines short-termism as a conscious (suboptimal) choice of lower payoffs in the short-term over higher payoffs in the long-term. The Kay report showed that there are incentives for this to occur at all parts of the investment chain: investors themselves, analysts, asset owners, intermediaries, asset managers, companies.

But the rhetoric that have evolved into the terms “short-term” and “long-term” being used to describe “bad” and “good” behavior is problematic. Short-term investment tactics have a legitimate role to play in terms of risk and liquidity management, etc.

- **Looking beyond public equity markets**

Long-term sustainable growth is dependent on having diverse sources of financing and particularly the supply of patient capital. So there is an obvious connection between the sustainable finance agenda (and the short-termism debate within it) and the CMU agenda. We should avoid approaching the short-termism debate purely from a listed equity point of view. There are different sources of capital out there: public equity, private equity, venture capital, debt, private placements etc. Each type serves a different purpose and tends to have its own “natural” holding period. What is short-term will vary depending on what asset class we are looking at.

There is also a question of what trends we are seeing in how companies raise money. It won’t help if we focus all our energy on listed equity when we know that an ever decreasing number of companies choose the public market route.

- **Stewardship**

We would like to highlight the importance of stewardship (meaning engagement and exercising shareholder rights) as means to foster long-term value creation. Asset managers’ engagement with companies is a visible “symptom” of their long-term approach in investments. Asset managers engage on all issues because they consider them to be important determinants of companies’ long-term sustainability and value.

- **Aggregate market data may be misleading**

There are many different players in capital markets with different investment horizons. There are high frequency traders that use the stock markets purely for speculative purposes and there are long term investors such as asset managers. In the UK for instance, it is estimated that the latter account for only 25% of daily turnover. So using aggregate trading data on stock exchanges are a reflection of the broader market but not asset manager behavior specifically.

- **Portfolio turnover is not a good measure for a long-term / short-term horizon**

Asset managers’ portfolio turnover reflects: 1) inflows and redemptions from investors (in line with the “agency” nature of the asset management business), and 2) portfolio adjustments due to market conditions, and therefore is not an appropriate measure of “short-termism”. This is reflected in the Global Investment Performance Standards, which stipulate that all returns must be calculated after the deduction of actual transaction expenses incurred during the period (6.A.7.): https://www.cfainstitute.org/-/media/documents/code/gips/gips-handbook-3rd-edition.ashx.

It is preferable to look at the holding periods of individual holdings in a portfolio, as this will show a long term holding of strategic (‘core’) investments and shorter-term holdings of other investments.

Asset managers are not in the business of turning over the portfolio, rather they seek to achieve a return against a desired risk profile for their clients. Meanwhile, transaction costs drive down performance and are therefore not be sought after by the asset manager. However, portfolio turnover is part of risk management.

- **High Frequency Trading**

HFT has been criticized for "creating noise" in the market, potentially making it harder for long-term investors to place the orders. EFAMA is firmly opposed to predatory HFT practices which seek to manipulate the market or disadvantage all end-investors. These practices constitute market abuse and should be treated as such by law. Exchanges and regulators need to establish a robust framework to surveil and identify abuses, and to act on manipulative practices when found. Furthermore, regulators need to assess where loopholes may exist and work to close them.

However, HFT encompasses a wide variety of trading strategies and care must be taken to differentiate predatory practices from those benefiting end-investors, including over the longer term. E.g., "electronic market making" is a HFT type benefiting clients through tighter spreads and by delivering intermediation in a fragmented trading landscape. Moreover, HFT is difficult to distinguish from computer-based trading tools such as algorithms or smart order routers which are used by market participants to execute orders for institutional and retail investors. All are characterized by low latency and infrastructures and automated order management. But, electronic market making and algorithmic trading are both activities which are legitimate elements of market structure and help asset managers to achieve best execution for clients. As such, we have consistently urged regulators to consider carefully how HFT should be defined, avoiding generalizations from one subset of HFT activities to the wider trend of an increased use of electronic trading in the markets, and the impact that policy decisions will have on these beneficial market activities.

- **Process & format of the questionnaire**

Regarding the process, we would like to point out that both we and our members found the deadline of one month during the holiday period very difficult to comply with. This is likely to significantly reduce the number of industry responses.

Moreover, in our view the format of the questionnaire does not allow to properly express our views (in many cases comment boxes are available only in case of certain options selected). Some questions do not allow to provide the accurate data.

E.g. Q50 asks to provide closest applicable % offering e.g. 0 or 10. But in case a company has data that they use between 0 and 10% of CDS, choosing neither 0 not 10 is really appropriate. Given the importance of this topic, we would have hoped for a more open dialogue and possibility to express our views, especially on some sensitive political and complex topics like remuneration of asset manager on which survey sections did not offer any opportunity to comment for associations.

Another examples includes questions like II.8 and II.11, where it all varies and therefore we question whether providing an aggregate figure is useful. Meanwhile, for many questions, e.g. Q II.13 the answer is "it depends" but the questionnaire does not really provide such an option or possibility to explain.

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