Capital markets and industry

Mr D A Walker, an Executive Director of the Bank, discusses[1] the implications for British industry of the changes taking place in the capital markets and, in particular, an intensification of pressures causing the markets to be influenced by short-term considerations. While accepting that the sharper attention of institutional investors to short-term performance has brought some positive results, he argues that the need for long-term commitments and investment strategy in industry requires an ability to take longer-term views in boardrooms and confidence that institutions are ready to be long-term holders; and offers three possible approaches to mitigating the problem:

- *Institutions could agree to set aside part of their UK equity portfolios in respect of which they would deliberately take a longer-term view.*
- *Company boards could seek to encourage greater shareholder awareness of their longer-term strategy by disclosure of planned spending on innovation to yield new products over a run of years ahead.*
- *Mergers policy might give more explicit attention, on a discretionary basis, to other considerations as well as the competition criterion in appraisal of merger proposals.*

Capital markets are undergoing exceptionally rapid change, both here and elsewhere. Elements on the international plane include fierce competition among major securities houses, the growing involvement of banks in securities business and in lending in securitised form, and the growing institutionalisation of savings. Domestically, we have the prospective abandonment of fixed commissions, an end to mandatory single capacity in The Stock Exchange, and the development of well-capitalised financial service groupings. It is noteworthy that these changes in capital markets have largely been driven by securities industry practitioners and investors, with issuers standing on the sidelines, rather unsure of what is happening and of its implications for them.

In the remarks that follow, I want to concentrate on the implications for domestic industry of the capital market and other changes that are currently in train at the frontier between finance and industry, and I will refer to international developments only where they affect that relationship.

Change in the securities industry

It is not difficult to see what benefits might be expected from the present changes for securities industry practitioners and investors. For UK practitioners, there is a fast-growing world market with large opportunities both for specialists and for conglomerates offering a wide spread of products. The relaxation of restrictions in The Stock Exchange and relatively free entry, boosted by a bull market and a halving of stamp duty, have created a heady atmosphere of challenge and enterprise in which many will do well—though some losses are unavoidable. For investors, above all the institutions, there is the prospect of lower transactions costs, prospectively more liquid markets, at any rate in the major stocks, and the ability to deal with a wider array of both practitioners and instruments in well-regulated markets.

The effects on issuers are less clear-cut. It is a fair generalisation that most listed companies have been reasonably served by financial institutions and the capital market over the past decade. One major problem, their reluctance to tap the bond market, has been mitigated by the growth of term lending by the banks, and it would be hard to make a case that companies have been seriously constrained recently in their recourse to the equity market. But while institutional investors and practitioners are in the market the whole time, the finance director or chairman of even a major listed company understandably regards capital-raising in the markets (as distinct from debt from the banks) as a major and comparatively rare event, and thus tends to be less closely involved in and less sophisticated about capital market developments. It is interesting to observe in this respect that finance directors have become—over the past decade—immensely more sophisticated in their relationships with their bankers. This reflects in part the vigour of competition among banks as corporate lenders over the past decade, perhaps almost an excess of supply, which put good quality borrowers in a very strong position and enabled them to attract very fine terms in many cases. It

(1) In a speech to the Glasgow Finance and Investment Seminar, on 24 October.

will not be surprising to see increasingly from now on a wooing of finance directors by securities firms and, for example, an increasing proportion of corporate debt in marketable form.

Taking the present capital market changes in isolation, the immediate implications for issuers may be quite limited. There will be more liquidity in markets in major shares, and this means access to capital at lower cost than would otherwise be the case. But there may not be much enhancement of liquidity in the middle rank and smaller listed stocks. And whereas institutional investors enjoy the benefit of access to a wider and better capitalised array of practitioners, this access is limited for corporates by the working of the pre-emption rights provisions. I do not want to take this subject as a central theme, but I offer two comments.

First, there is a tendency to discuss pre-emption rights in black and white terms. This is unhelpful, for while there seems little case for, or prospect of, changing the companies legislation provisions in this respect—that is, the requirement for a special resolution in respect of proposals to issue shares other than to existing shareholders—there are lesser questions that seem eminently worthy of discussion. The issue for the immediate future is not whether pre-emption rights are retained, but whether restrictions superimposed by The Stock Exchange over and above those in companies legislation might not be interpreted somewhat more flexibly. There has sometimes seemed to be a reluctance on the part of institutional investors to acknowledge that present changes in capital markets will not stop at lower dealing costs and that other matters, perhaps as important for them as fixed commissions were for Stock Exchange members, will have to be faced.

Second, although there has been little interest hitherto on the part of companies in bought deals, the growing pressure from securities houses that are capable of offering such arrangements, and the fact that for the company itself as an operating entity a bought deal may cost less than a rights issue, suggest that argument for at least a marginal easing in the rules is likely to become increasingly insistent. The question is posed most immediately for institutional investors, who have the option of declining to support special resolutions, though it is not in their long-term interest to deny to the companies of which they are shareholders access to capital on terms that may be cheaper than the rights issue route. Given the growing competition and pressures for greater flexibility that are now so much in evidence in the capital market, it seems inevitable that, at the end of the day, companies will be able to find their way to the cheapest source of capital, rather like water finding its own level.

Institutional time horizons

I turn now to pressures which, though intensified by the changes currently in train in the financial service area, have their origins further back. The particular pressures that I have in mind are those causing capital markets to be increasingly influenced by short-term considerations, and they have consequences which are much more difficult to accommodate than, for example, the move to negotiated commissions and dual capacity. These pressures have a wide array of sources.

The first is the move to, and maintenance of, high real interest rates which, with habits of mind engendered by the high inflation phase of the 1970s, has focussed attention on short-term yields, forcing companies to look for very high expected real rates of return from long-term projects. The second is the increased concentration of savings and thus of shareholdings in institutional hands, where portfolio management policies tend to be more professional and active. The third is the enterprise of securities houses and others who, in marketing an array of new financial instruments (many designed to hedge risk), have further widened the potential scope for investment management and possibilities for gain through more active switching policies. All these changes are amplified by the more active securities market being encouraged by current changes in The Stock Exchange and elsewhere. Fourth, there is the separate but parallel process of deregulation which has affected users of capital markets, most notably the abandonment of exchange controls in this country and relaxation in the administrative provisions governing investment opportunities for American pension funds.

These pressures are growing internationally, not only in the United Kingdom. It is relevant to compare the turnover experience in equities of the stock exchange in London, Tokyo and New York. While turnover as a proportion of end-year market value remained fairly stable in London at 18% between 1974 and 1984, the Tokyo figure showed a rise from 30% to more than 40% and that in the New York Stock Exchange from 20% to 50%. The New York figure has been even higher, and even the figure quoted here is probably an underestimate of the overall market turnover ratio for the United States, given that many stocks are quoted elsewhere, above all on NASDAQ, which has become much more significant over the past few years and is an extremely active market. To the extent that the UK capital market is increasingly influenced by and, indeed, effectively in competition with the US market and its practitioners, it seems realistic to expect to see an increasing turnover here.

Taking a different criterion of turnover activity, the sum of institutional purchases and sales of UK equities as a proportion of end-year market value, the tendency to increased activity is very clear, even though recent vigorous turnover is influenced by bull market conditions. To give two examples; the percentage for insurance companies was 11% in 1979 and 18% in 1984 and that for unit trusts was 35% in 1979 and 54% in 1984. The proximate pressures that are responsible for this are clear enough: that is, the increased attention to performance on the part of portfolio managers which, since it is measured only on a short-term basis, means that

they are unavoidably driven to concentrate on the short term rather than the long haul.

There is an understandable tendency to see only the negative side of this apparent foreshortening in the time horizons of investment managers. But it has undoubtedly brought both direct and indirect benefits.

First, the fact that companies are more conscious of and alert to institutional shareholder attitudes has exerted a beneficent effect in many cases in keeping chairmen and boards on their toes, and has played a part in the sharpening up of efficiency in British industry. There is a valid criticism here that still more benefit of this kind would accrue if institutional shareholders were still more ready to press on companies their concerns to see improved performance.

Second, increased institutional interest in short-term switching possibilities has boosted turnover and worked to increase market liquidity. One of the elements in the equation which determines the cost of capital is the liquidity of the market in which a company is issuing or borrowing, and more active trading by institutions which reflects shorter time horizons tends to reduce this element in the cost of capital.

Third, and the most difficult benefit to assess, is that portfolio management related to short-term performance is not necessarily inimical to long-term performance in industry. Gauging the attractions of an equity largely by reference to recent and current earnings performance may fail to capture information relevant to the long term, such as the prospects for new product development. But there is no necessary presumption that a company that performs well in the short term will do less well in the long term; nor is it clear that a company which is faring badly in the short term can be depended upon, with time, to sort out its problems and to do well in the long run. There are many reasons for doing badly in the short term that could apply with still greater force over a longer period. This is obviously not to say that the right course for the institutional investor is always to foreswear a long-term view on the basis that the best long term is a succession of satisfactory short terms. But nor does the opposite hold, and it is plainly desirable for a portfolio manager at least to have regard to current board, management and product performance in thinking about future potential.

Lastly, although companies as issuers are only indirect beneficiaries, the increased activity of portfolio management has fostered the development of a specialisation, portfolio management on a competitive basis, in which British houses are strong and successful, and which has become a major export activity.

Importance of the long term and board attitudes

But there are other perspectives as well as those of the portfolio manager, and I want to refer to two which are vital. The first is the importance for our future of developing new products and services which, in many cases, will require long lead times. Their importance is underscored by the intensity of international competition in standard product areas where, despite the large efficiency gains achieved over the last few years, the actual or prospective comparative cost position of British producers is often weak. The better position would be one in which British firms were to a much lesser extent price-takers in products where cost competition is critical and, to a much greater extent, were marketing products where cost and price matters less, that is, where we can be price-makers. But such products tend to involve long lead times, which means substantial foresight and the ability to make a significant advance commitment. In other words, there is a problem of how to reconcile short-term horizons of portfolio investors with the need for boards to make long-term commitments to particular lines of R and D, product development and capital spending.

The second problem of perspective relates to the capabilities and attitudes of boards themselves. One of the consequences of the recession phase, indeed the means of getting safely through it for many companies, was that boards were obliged to focus on short-term survival, and to gear their policies correspondingly. Those that did not satisfactorily manage their liquidity position came under the most disagreeable external pressure, and conversely. While recession gave way to comparative boom conditions, and many companies have seen a massive improvement in their financial position, the preoccupation with short-term return has remained. This is hardly surprising, given the searing experience of recession, not lightly to be forgotten, and the inducement to hold financial assets as a result of the persistence of high real returns on them.

But beyond these reasons for board concern with the short term there is the fact that, disagreeable as the need to focus exclusively on survival may be, it tends to involve much less intellectual and imaginative business endeavour than choosing a long-term strategy. Planning for long-term survival in an environment that is cash-rich may be much more difficult than striving to survive in a situation of severe short-term pressures. This problem is now reinforced for British boards by a complex of factors that are perhaps best summed up as their perceptions and apprehensions about the behaviour of others, including their shareholders. Over and above the fact that horizons of institutions have shortened, we have the phenomenon that boards may often believe them to have done so to an exaggerated extent and thus adapt their own behaviour and decision-taking accordingly, with large efforts made to avoid short-term earnings dips.

These concerns are sharpened by the much greater apprehensions at the risk of takeover which, given the rapid acceleration in acquisition and merger activity, is hardly surprising. It is worth recording that, whereas the value of mergers and takeovers was £1.1 billion in 1981, it rose to an average of about £2.3 billion a year in 1982

and 1983, £5.5 billion in 1984 and is currently running, in 1985, at an annual rate of nearly £8 billion. The ratio of expenditure on acquisitions and mergers to domestic gross fixed capital formation has been running this year at some 40%, far higher than at any time since the early 1970s.

These factors may be exerting significant effects on corporate behaviour. They underscore an attitude that attention to the longer run is a luxury and risk that can be indulged only within tight limits, especially by companies that see themselves as potential takeover targets. And if US experience is observed, defensive action taken against unwanted bids can involve leaving the operating entity with substantially higher gearing as a result of which its capability to make long-term commitments is reduced. This gearing problem is abundantly clear in the United States where, as a result of the use of techniques such as junk-bond financed acquisitions and leveraged buyouts as means of preventing them, the underlying business at the end of the day is saddled with a much larger burden of debt. This has not to any great extent been a phenomenon in this country so far, but it is far from certain that we will be able to avoid it.

Elements in a way forward

So far, my concern has been with diagnosis. I do not apologise for giving it so much attention for, if it is mis-specified, the prescription will only be right by accident. But in a general way it is reasonable to ask what might be done to ameliorate the problems that I have described.

One family of proposals would involve obliging institutions to repatriate part of their foreign portfolios and to invest the sterling proceeds at least partly in or through a new national investment institution. It is not my concern here to consider the merits of the proposed National Investment Bank and the combination of special fiscal arrangements and directed investment that go with it. Ultimately, the question whether we have such an institution is a political one.

But while an initiative on these lines could make more certain the channelling of funds to long-term capital projects that are selected as particularly desirable, it is unclear what its effect would be on the funding of other projects and companies in which an NIB was not involved. Indeed, if the way in which the scheme operated was, as seems likely, to limit the investment freedom of investment managers in respect of part of their portfolios then, unless other circumstances change, it is entirely likely that managers would place even greater emphasis on the short-term performance of the remainder of the portfolio, untrammelled by policy or regulatory fiat. The effect could thus be to make for still more active management of the 'free' part of portfolios so that, in respect of such holdings, the preoccupation with short-term performance would intensify. While an NIB could promote longer-term investment decisions in the areas in which it chose to concentrate, its very existence, and the restrictive arrangements that would underpin it, could exacerbate the short-term horizons problem in other areas. It would thus remain of great importance, as it is now, to consider how the taking of longer-term views by both institutional investors and boards can be encouraged.

Let me therefore briefly explore some possible approaches or suggestions with implications for investors, for boards themselves and for government.

The first is to suggest that institutions should set aside or hypothecate part of their UK equity portfolio in respect of which they would deliberately take a longer-term view. To some extent, this goes with the grain of what some large—and some not so large—institutions have already chosen to do, for example in committing a specified percentage of their portfolios to non-listed stakes in 'hi-tech', or small ventures, or both. The merit of a spread of this approach is that it would help to establish and secure acceptance that part of the UK equity portfolio of an institution need not be so actively turned over in the market, and the more institutions accepted this, the easier it would be for any one manager deliberately to choose to hold particular stakes on a term basis. An individual fund manager cannot readily withdraw on his own from the short-term performance business but might feel able to do so in respect of part of his portfolio if he were confident that others were proceeding similarly.

Cast in other terms, such an approach would acknowledge that a fund manager should have more than one objective. The concentration of savings has concentrated large influence in some investor hands and the managers concerned are properly interested in maximising some combination of capital gain and income in a particular time period. But, if the timescale is so uniformly short that other priorities suffer, the risk of policy interference to limit institutional freedom of manoeuvre is bound to increase. In this situation, it seems worth considering whether institutional investors might not disclose, perhaps on an annual basis, the turnover of different parts of their equity portfolio and some indication of the broad areas by which they expected to be relatively committed holders in the period ahead, and of the portfolio percentages involved in them. This would not of course involve commitment to holdings in any particular company but, by reducing the proportion of equity portfolios in respect of which short-term performance is expected, it would help to redress the imbalance in the present situation.

Second, while there is concern in boards that shareholders take unduly myopic views, it is hardly the case that British boards generally encourage shareholder interest in their strategy. Few listed companies identify the scale of R and D expenditure in their report and accounts. The total of R and D spending can be a highly imperfect guide to the future direction of a company—while it may be vital for

successful innovation in one company, it may be altogether irrelevant in another. But a reasonable question is what alternative information is available to a major shareholder who is interested in the long-term performance of his company? A specific proposal for consideration, potentially much more useful than publication of R and D figures, is the presentation by listed companies of what might be termed an innovation statement. This would comprise an indication of the overall expenditure, whether revenue or capital, marketing or R and D, being geared to new products or services that would reach the market in, say, one, three and five years' time. This would be in line with regular board and management information within many companies and, although problems of commercial confidentiality would arise in some cases, they should not be insuperable.

If a start could be made by major companies with enhanced disclosure on these lines, it could offer institutional investors two things. The first would be to set a good foundation for a possible long-term shareholding relationship. The second would be leverage over boards that chose not to disclose such spending and the forward planning to which it would relate. In the latter case, the failure to disclose might be explicable in terms either of there being no such spending to disclose, a problem in itself well worth having smoked out; or an implication that the board was unconcerned about long-term shareholder attitudes and support, again a relevant signal to the market. It is hard to see how a board could consistently argue against disclosure on these lines while at the same time criticising the myopia of its proprietors, whose ability to take a longer view is bound to be influenced by their knowledge or ignorance of the developments being planned by the company itself.

Third, there is increasingly the question how far official attitudes to merger and acquisition activity remain apt in the present fast-changing market environment. The competition criterion is the principal element in present mergers policy and this policy is indeed seen as an important part of the wider concern to promote competition. Yet the essential lines of present mergers policy were set at a time when takeover activity was running at only a fraction of its current pace. The ratio of expenditure on mergers and acquisitions to domestic gross fixed capital formation was 29% in 1984 and still higher in 1985, much higher than at any time since the early 1970s. With mergers activity running so vigorously and, indeed, aggressively, boards are increasingly apprehensive at their vulnerability. This concern, with the absence of confidence in most cases that the mergers legislation would be used to obstruct an unwanted bid, is no doubt reinforcing in many boards the disposition to be cautious about innovation expenditure which reduces profits in the short term.

None of this challenges the importance of the competition criterion. Many mergers of recent years have brought large efficiency gains which it might have been difficult to achieve in any other way. My concern; however, here is not with the direct effects of mergers that do take place but with the indirect effects of the widely diffused fears that unwanted mergers might take place. The influence of their perceived vulnerability on the attitudes and decision-taking of boards involves a real cost, and this is as much a matter of public interest as the public interest in competition and efficiency. Whereas the competition and efficiency benefits can only accrue where mergers take place, the cost through reinforcement of board caution is felt widely across much of the corporate sector. Precisely because the cost aspect is diffused and unquantifiable, it is impossible to convert it into an additional public interest criterion that could be applied, alongside the competition test, in individual merger propositions. But to the extent that the concerns described here are well founded, the question remains whether there is any adaptation of mergers policy that might help to mitigate them.

A good deal of emphasis has been placed on the importance of stability and predictability in mergers policy. As a general rule, it is plainly desirable that uncertainty about government policies that affect private sector decision-taking should be kept to a minimum. But in respect of mergers, an asymmetry has emerged in the sense that the declared policy emphasis on the competition criterion has increased the certainty of the position of offerors who have little or no existing involvement in the sector of business carried on by the offeree. It has, in practice, thereby increased the uncertainty and vulnerability of offerees. This asymmetry was no doubt unintended. But it appears to be real enough, and it is difficult to see how it could be offset even partially without an indication that other considerations, apart from competition as it has been interpreted hitherto, may be taken into account on a discretionary basis in appraisal of merger proposals.

One question is whether it is as appropriate as it once was that the competition test should be applied purely in domestic terms in a world in which international trade and multinational sourcing has assumed such significance. A particular takeover proposal might not reduce competition domestically but it might do nothing to enhance, and could reduce, the ability of a UK-based business to compete in the world market. It would not seem inappropriate to take such considerations into the reckoning. Others might include the likely effect of a merger on the gearing of the offeror, the offeree and the combined group, and on the nature of any disposals programme that an offeror might need to implement, if the bid were successful, to realise sufficient cash to repay debt accumulated to finance the acquisition. Quite apart from the implications of higher gearing for a particular business, there would also be a wider public interest concern if financing techniques in takeovers, and action taken to repel them, seemed likely to raise the overall gearing of the corporate sector in the way that has been experienced in the United States.

None of this is intended to suggest a precise or mechanistic approach to such considerations. The problem is in a sense

that present arrangements, focussing on competition aspects, themselves have a very mechanistic aspect. In this situation, part of the object would be to redress the balance of uncertainty to some extent in the direction of offerors and, by the same token, to provide a degree of assurance to potential offerees that policy might afford them some protection even where an unwanted bid came from an offeror where no competition problem arose.

Having heard my diagnosis of the problem—shorter horizons militating against long-term investment decisions—many of you will wonder whether the three suggestions that I have put forward really meet the bill. They are obviously not panaceas, and I believe that this problem of time horizons and perspective is protean in its complexity, one of the most difficult economic problems with which we have to contend. I suspect that the only sure way forward is to aim to work on several fronts simultaneously. But the problem is urgent as well as being very difficult and, unless and until others can think of better, the approaches outlined here seem worth further exploration.