



COMMITTED SHAREHOLDERS: DILEMMAS OF THE DUTCH INSTITUTIONAL INVESTORS

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Committed shareholders

Dilemmas of the Dutch institutional investor

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1. Introduction

We are fortunate to live in a time when many assumptions about the role of finance in society are revisited and altered. Recent years have witnessed a change from the neoclassical investment paradigm to a broader view that incorporates environmental, social, and governance factors (ESG). Over 25% of the assets under management (AUM) globally are invested in accordance with certain ESG metrics. Many prominent institutional investors have joined the sustainable investing movement, including the Government Pension Investment Fund in Japan, the Government Pension Fund Global in Norway, and several Dutch pension funds, including ABP and PGGM.

However, the transition to sustainable investing poses several challenges for the investors. The ESG challenges and opportunities are broad and difficult to measure. Simultaneously, the knowledge on the subject and how it can translate into concrete investment strategies is relatively scarce. At the same time, sustainable investing is entering the mainstream in the Netherlands, necessitating the development of a common language of sustainability and greater understanding of the mechanisms by which it can be realised.

As a follow-up to the report on the institutional ownership of the AEX 25, in-depth semi-structured interviews were conducted with a sample of 21 participants from the asset management industry and Dutch corporations (portfolio companies).

The paper finds that investors use a variety of methods for long-term value creation, including positive and negative screening, concentrated portfolios, active ownership, and collaboration with other investors. The main barriers to long-term investing are overreliance on benchmarking and passive portfolios, lack of alignment within the investment chains, and short-term performance incentives in the industry. Those are exacerbated by the lack of reliable sustainability data and the decoupling of investment processes from ESG engagement.

On the corporate side, the main challenges lie in short-term pressures from the financial community, the risk of sustainability products not gaining traction in the market, and the difficulty of reconciling the interests of different stakeholders in the pursuit of long-term value creation.

In the previous article on the subject¹, we estimated that Dutch institutional investors have a minor presence in their domestic market (2.05% of the outstanding AEX shares). However, it may be beneficial for the Dutch asset managers to invest more in the domestic market due to a shared view of long-term value creation.

¹ AEX Institutional Ownership Report (2018), *Erasmus Platform for Sustainable Value Creation*

2. Interview Participants

Among the asset managers interviewed, most of the participants are actively involved in ESG/impact investing (67%) and long-term investing (58%). A disproportionate number of participants also manage concentrated portfolios (50%), as opposed to passive index-tracking portfolios, which are more common among institutional investors. Therefore, their sustainability awareness is likely higher than that of an average asset manager. The self-selection argument applies to the interview participants from the corporate side. However, as the interviews were performed to produce an account of the challenges and the best practices in long-term value creation, arguably, the recruited participants were more qualified to speak on the subject. Additionally, external perspectives (e.g. from the asset managers with passive mandates or funds-of-funds) were also included in the sample, albeit to a lesser extent. On the corporate side, a diverse set of industries was represented in the sample, including companies in the technology, FMCG, chemicals, healthcare, and insurance sectors, with different approaches to sustainability and different challenges.

In total, 21 participants took part in the study, representing 10 asset management firms and 8 corporations. The interviews took place from July to November 2018. Collectively, the asset management firms which participated in the research manage €1.3 trillion of assets. On the corporate side, the participating firms represent €330 billion in combined market capitalisation.

Although the individual identities of the participants were disguised for confidentiality, the aggregate statistics are presented in *Appendix I*.

As can be seen in *Appendix I*, pension fund asset managers represented half of the sample within the institutional investors group. The second most-prevalent category was (non-pension fund) asset management companies. In terms of the job roles, 42% of the participants among institutional investors were portfolio managers. Except for one sustainability expert and one active ownership specialist, all participants managed equity portfolios. 2 of the 12 participants selected external managers.

On the corporate side, 7 industries were represented in the sample. 67% of the participants held investor relations roles within their organisations, although C-suit executives and board members were also included.

3. Results

3.1. Interviews with Investors

3.1.1. Defining LTVC

In the first part of the interview, the participants were asked to define long-term value creation for their company and the industry where it operates (asset management). The participants were not specifically primed to think about the long-term value creation in financial or sustainability terms. The objective of the question was to determine what the investors considered to be essential elements of long-term value creation.

All responses incorporated financial metrics of value creation, such as portfolio returns for investors and return on invested capital (ROIC) for portfolio companies. While some participants named sustainability performance as an independent facet of value creation, other participants saw sustainability mainly as a pre-requisite for long-term financial returns.

Definitions of the long term varied from 5 years to 20+ years, highlighting significant differences between the investment horizons of different financial institutions. The longer the investor's stated horizon was, the more factors they tended to include in the definition of long-term value creation. Several representative definitions given by the investors are shown in Table 1.

LTVC component	Long holding period	Long-term DCF forecasts	Stakeholder approach
Explanation	Long holding period (low portfolio turnover) and resilience to short-term performance fluctuations. Thinking like a business owner rather than a shareholder.	Using DCF analysis to value a company, typically with an explicit forecasting period of 10 years. Identifying long-term value drivers for the forecast.	A holistic approach to performance that includes the environmental and social returns of the company (ESG).

<p>Key quotes</p>	<p><i>“It’s very important that [...] that you can withstand short-term volatility, and maybe short-term negatives, or short-term investments that need to be done for long-term gain.”</i> <i>CIO, Pension Fund Administrator 1</i></p> <p>“When we say “long-term”, we mean that we want to be owners rather than shareholders, and that we want to own these shares for the long-term and be a partner for these companies.” <i>Head of Equities, Pension Fund Investment Manager 2</i></p>	<p>“It’s a matter of taking a very long-term perspective, using a DCF model, not multiples. I would model the company at least 10 years out in the DCF.” <i>Senior PM Impact Investing, Asset Management Company 1</i></p> <p><i>“We try to take everything into account that might come into play in the long run. We try to capture that in our analysis: In our financial analysis—that’s on a DCF basis—which encompasses the entire future of the company, to the extent that we can see it.”</i> <i>Head of Equities, Pension Fund Investment Manager 1</i></p>	<p><i>“Long-term value creation means that companies maximise financial returns and social and environmental returns. And, of course, there will be trade-offs between the three of them, but it means that they at least avoid sacrificing one of the three to the others.”</i> <i>Senior PM Impact Investing, Asset Management Company 1</i></p> <p>“We define value creation not just for the shareholders, but for all stakeholders.” <i>CIO, Asset Management Company 2</i></p>
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Table 1. LTVC Components (Institutional Investors)

3.1.1.1. Long Holding Period

There are many advantages to having a long holding period. It enables the investor to incorporate long-term value drivers in their valuation, endure short-term performance fluctuations, and abandon the often-futile search for short-term share price catalysts in favour of fundamental investing. Coupled with active ownership, a long holding period can lead to a productive cooperation between investors and companies, increasing their focus on the long-term, strategic issues.

“And if you invest in lots of companies, you make 80% of your return in 20% of the time, but you never know exactly which month it is going to happen. And there are still managers that tried to pinpoint it and to get that sweet spot

every time, but that's in my view much too ambitious. You are never able to time that. You should just invest, be patient, and give it 3, 5, 8 years, and at some point it [outperformance] will come out." – PM, Pension Fund Administrator 2

A long holding period also means that there is an increased likelihood of long-term projects with delayed payoffs to be realised. This is certainly important for corporates, for example, in the context of investing in developing markets that will become lucrative in the distant future. Even more strikingly, long-term investing becomes crucial in the context of solving the world's challenges, for example, by developing innovative technologies:

"Companies like Illumina, for instance, speed up the discovery of medicines with artificial intelligence. Certain technologies allow you to make personalized medicines for cancer, for instance. These themes are very long-term, and they [the asset manager] accept that the stock may go down 100%. [...] If they have a few stocks that go up 1000%, they are happy. They accept that risk. But that only works out in the long run, not on a 1-year horizon." – PM, Pension Fund Administrator 2

The main caveat to that vision is that a long-term investment horizon does not always translate into a long holding period, as pointed out by several asset managers interviewed. Although the terms are often used interchangeably, they can have different meanings in the asset management industry.

The investment horizon is defined by the interviewees as the time between the outflow and the inflow of funds to the *asset owner*. It corresponds to the amount of time that the asset manager manages the asset owner's funds. For pension funds, the investment horizon can be as long as 20 years, sometimes even longer. Conversely, the holding period is defined as the average time an investment is held by the *asset manager* in their portfolio.

Although it would seem logical for institutional investors with a long-term investment horizon to have portfolios with long holding periods, this is not the case under the current industry setup:

"In an ideal case, our holding period would also be 25 years [equal to the investment horizon], but that's not the case, of course. It depends on the mandate. For passive mandates, we just follow the index, and lots of names just stay in there for 10-20 years, so we have long-term horizon. If we give an active mandate to an investor, there is a certain turnover in the portfolio. There are different mandates with different turnover numbers. Some of these strategies are more short-term, then the holding period is 2-3 years." – CIO, Pension Fund Administrator 1

Nevertheless, when long holding periods are successfully realised, they are highly conducive to long-term value creation.

3.1.1.2. Long-Term DCF Forecasts

Long-term DCF analysis is necessary to gain an understanding of the company's intrinsic value. It is especially important for long-term shareholders, who will

witness the company's share price evolve over a long period and therefore need to understand the fundamental drivers behind its valuation.

However, the equity research industry overwhelmingly caters to short-term investors. A recurring theme throughout the interviews was the prevalence of short-term company research in the sell-side of the industry.

"90% of the sell-side research is not interesting because it's short-term research." – CIO, Asset Management Company 2

Short-term research is not informative for long-term shareholders for two reasons. First, it is often performed using relative metrics (multiples), which only provides information about the company's relative price compared to its peer group, but not its intrinsic value. Second, short-term research provides a snapshot of the company's present instead of modelling its future. Alternatively, in the case of sell-side DCF analysis, little consideration is given to modelling the future cash flows. "Many financial analysts are just extrapolating stuff," said one interviewee, referring to the sell-side DCF analysis.

At the same time, long-term projections can make a dramatic difference in the valuation of a company.

"What you forecast for years 4 to 10 makes a huge difference for your valuation and for your terminal value. If I am slightly more optimistic on the company's profit margins, or sales growth, or cost of capital, I get a higher valuation." – Senior PM Impact Investing, Asset Management Company 1

For those reasons, long-term shareholders typically use a long-term DCF analysis in their investment cases, with an explicit forecasting period of up to 10 years. The DCF method is often used in conjunction with sensitivity and scenario analyses to ensure the robustness of the model.

Having conviction in the long-term value drivers can reveal that companies with more sustainable business models look more financially attractive relative to the rest of the investment universe. They may also be less susceptible to long-term risks, such as resource depletion or rising carbon prices.

Projecting the company's future performance also requires the investor to incorporate the externalities that the company's products and services create, even if they are not reflected in the current share price. And the longer the investor's horizon is, the more likely are the externalities to be reflected in the valuation, highlighting the true costs of the company's operations:

"The longer your horizon is, the more externalities will be included. You may have a better return in the short term by sacrificing what are now externalities; in the long run that will have a negative effect on your returns, and then, on balance, the returns may be less than if you take them into account to begin with." – Head of Equities, Pension Fund Investment Manager 1

Naturally, a high confidence level is required to invest in a company on a basis of a long-term analysis at it is inherently uncertain. Therefore, in-depth research and

company due diligence are typically used in conjunction with a long-term DCF analysis to ensure high quality of investment decisions.

3.1.1.3. Stakeholder Approach

While financial returns remain central to the asset management industry, the interviews reveal that institutional investors increasingly pay attention to the environmental and social dimensions of company performance. The notion of long-term value creation includes the company's impact on its various stakeholders, for which ESG performance is often taken as a proxy.

"Portfolio managers, certainly in the past, were only focused on the value creation for the shareholders, our clients. But over the last 5-10 years, [...] the environment and the society have become much more important, and so have the other stakeholders." – CIO, Asset Management Company 2

Incorporating ESG in the investment analysis helps investors to reduce the financial or reputational downside (by excluding the worst-performing companies) or promote stakeholder value creation by investing in the best-performing companies. Ongoing ESG screening can also lead to engagement on specific issues to improve the company's ESG practices.

There is consensus among the investors interviewed that ESG performance and financial performance are related, at least in the long-term, although the interviewees have had difficulty articulating the exact nature of the relationship. Two themes often feature in their thinking on the subject. First, ESG performance is seen as an indicator of how well the company is managed. Second, ESG performance to some degree reflects the company's readiness for the transition to a sustainable economy.

One group of investors within the sample stands out as having taken the stakeholder approach further. Several interviewees have pointed out an additional underlying objective of their investments: generating positive impact for the stakeholders, such as environment and society, in addition to creating value for the shareholders/clients.

This approach goes a step beyond using ESG as a tool for risk mitigation or financial return enhancement. This framework requires deliberate selection of companies with a potential for positive impact, also known as ***impact investing***. It means that the portfolio is created with the goal of simultaneous return generation and impact generation, and investor's performance is evaluated according to both goals.

"In my fund, we will never buy a stock because it is cheap, what we start with is: Does it make a contribution to the SDGs? And from that we will start comparing within that group, where the others are simply out." – Senior PM Impact Investing, Asset Management Company 1

Overall, the interviews reveal that ESG is perceived as a material factor in long-term value creation. Although most investors ultimately associate value creation with shareholder returns, some investors aim to generate both shareholder and

stakeholder returns with impact investing. Impact investing is gaining traction among large institutional investors, so it is not beyond the realm of possibility that it will become widespread and eventually displace ESG integration as the new norm.

3.1.2. Instruments for LTVC

After defining long-term value creation, the participants were asked to elaborate on the role of institutional investors in promoting long-term value creation within the broader eco-system of asset owners, asset managers, and corporations.

The interviewees unanimously stated that institutional investors should play a role in promoting LTVC. When asked to elaborate, the interviewees focused on shareholder engagement as the most powerful mechanism of influencing companies.

The centrepiece of investors' responses was that long-term shareholders need to be vocal about their priorities. The topics that investors choose to discuss during the meetings with the management send a strong signal to the executives.

"It's generally about the subjects that you choose to speak about. If you're spending your hour with the top management talking about next quarter's earnings—or, last quarter's earnings, even worse—then you are wasting everybody's time and you are focusing the management on the wrong issues."
– Head of Equities, Pension Fund Investment Manager 1

"If you look at the investment chain, then pension funds are in the best position to be an actor in this sense. Everything behind us in the investment chain, for example, asset managers, the people who make benchmarks, the public markets, they in a certain sense deliver what we ask them to deliver."
– Prin. Director Investment Strategy, Pension Fund Investment Manager 1

The excerpts above are indicative of the overall sentiment among investors. Furthermore, there are specific engagement topics that were recurrently mentioned by the investors as facilitating long-term value creation, which are discussed in greater detail later in the text.

Throughout the interviews, asset managers discussed their strategies for long-term value creation. This section outlines the most commonly used instruments for long-term value creation mentioned by the interviewees. Not coincidentally, many of those instruments serve as enablers of shareholder engagement. Table 2 and Table 3 can be regarded as a toolkit of the best practices currently employed in the asset management industry in the Netherlands.

LTVC instrument	Positive and negative screening	Active ownership
Explanation	<p>Negative and positive screening provide a useful narrowing down of the investment universe. Negative screening is exclusion, whereas positive screening selects companies that have desirable characteristics for further analysis.</p>	<p>Engaging with portfolio companies proactively on long-term questions.</p>
Key quotes	<p><i>“We have positive selection criteria, so we are sort of excluding a large number of companies, but positively selecting a few companies.”</i> <i>Senior PM Equities, Pension Fund Investment Manager 3</i></p> <p>“Sustainalytics has a list of the “worst offenders” of the global conduct principles, and most investors exclude those.” CIO, Pension Fund Administrator 1</p>	<p>“We regularly meet the company, meeting the CEOs and CFOs, and that’s an integral part of being an asset manager: To have your voice heard, and to share your views on future strategy, business environment with the management regularly. A long-term view is essential in that. Quarterly earnings are not of huge interest to us. Most of the time, we discuss longer-term opportunities and threats, positioning, and strategy with the company.” Head of Active Ownership, Asset Management Company 3</p>

Table 2. LTVC Instruments (Institutional Investors) (1)

LTVC instrument	Large-stake, concentrated portfolios	Collaboration with other institutional investors
Explanation	<p>Concentrated portfolios enable the investors to engage closely with the companies, whereas large stakes in ensure that companies are receptive to their influence.</p>	<p>Collaboration with other investors increases both effectiveness and efficiency of shareholder dialogue.</p>

<p>Key quotes</p> <p><i>“Because we take a long horizon and because we tend to take >5% stakes of the companies we invest in, we intend to be active and involved shareholders in the companies where we have these positions.” Head of Focus Equities, Pension Fund Investment Manager 2</i></p> <p><i>“We have 5% stakes for certain reasons. We wanted to know the company inside out, we wanted to be involved if there was a takeover, for example. Because it was small-cap companies, there are lots of takeovers, and then we would be the first row of the negotiations. There was a fiscal angle to it. And we had the added benefit, from an ESG perspective, that we had above-average influence on the company.” CIO, Pension Fund Administrator 1</i></p>	<p><i>“At the last shareholder meeting of a Dutch oil & gas company, we had a joint statement with 16-17 investors, supported by many Dutch institutional investors, that’s a very strong signal. Collaboration is powerful in that respect. If a message is shared by several investors, it reinforces the message.” Head of Active Ownership, Asset Management Company 3</i></p> <p><i>“We wrote a letter to a Japanese car manufacturer to say that we were not happy with the way they treated their labour unions. We got a letter back thanking us for pointing out the issue and promising to look into this. And of course, it’s all bullshit. They just don’t care about a small investor in the Netherlands. What’s important for me is therefore to collaborate with other investors, especially when engaging with large caps.” CIO, Pension Fund Administrator 1</i></p>
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Table 3. LTVC Components (Institutional Investors) (2)

3.1.2.1. Positive and Negative Screening

All the investors interviewed adopt methods for company screening as part of the due diligence process.

Negative screening is used to avoid the most reputationally toxic stocks. Financial institutions in the Netherlands often have a company-wide policy on the exclusion of controversial industries (tobacco, nuclear weapons) or stocks from the investable universe. MSCI Research and Sustainalytics are two popular providers of ESG screening data for such purposes. Negative screening is used primarily for passive index-tracking or factor portfolios, although exclusion can also be applied to concentrated portfolios where engagement with the company did not lead to desired results.

“We try to keep them [stocks] in the portfolio for a long time and only throw them out if we are disappointed with one of the types of performance [F, S, E]. That is typically the company not being managed as well as we thought or hoped it would be.” – CIO, Asset Management Company 2

Positive (affirmative) screening is used as the first filter for narrowing down the investment universe according to some desirable characteristics. It is most commonly used for best-in-class and concentrated portfolios. Best-in-class portfolios consist of stocks that meet a set of minimum criteria for sustainability (a minimum absolute rating), or a minimum ranking hurdle (a minimum position in the ranking). Concentrated portfolios go a step further and use ESG ratings as a starting point for conducting additional due diligence on potential portfolio companies.

There are three types of additional criteria that have been used for positive screening by the interviewees: business metrics (high customer switching costs, high market share), financial metrics (low leverage, EVA), and impact metrics (contribution to SDGs).

Generally, negative screening is a practice that helps to establish financial institutions’ social license to operate and steer them away from controversy. In contrast, positive screening has the potential to provide additional benefits, for instance, by serving as a proxy for company’s “quality”, as the next example shows. The investor in question screened the stocks according to their role in reaching the UN SDGs.

“We went through 15,000 stocks, and there are 2,200 stocks that are called “Impact”. First of all, that is a lot more than we thought; Secondly, they are higher quality than the rest of the universe. So, it’s higher growth, higher margins, low risk. It’s a useful narrowing of the universe.” – Senior PM Impact Investing, Asset Management Company 1

This is not an isolated example. Although interviewees have used different selection criteria in their investment approach, most of them attest to secondary benefits of positive screening. For example, positive screening has been cited as a tool to limit the long-term permanent impairment of capital.

3.1.2.2.Active Ownership

One of the common refrains among the interviewees was that active ownership is a key enabler of investing for long-term value creation. Active ownership as defined by the interviewees should be distinguished from shareholder activism from a U.S.-based perspective, which focuses on short-term improvements and often opposes the management. In contrast, the model of active ownership practiced by the investors in the sample is one of continuous dialogue with the company and being a partner in long-term value creation.

The active ownership model practiced by the Dutch institutional investors is different from that of their North American counterparts in two other key aspects. First, there is no aim of generating publicity through high-profile campaigns. As one of the interviewees put it:

“We aim to have a constructive dialogue, we are not aiming for headlines on the front page of the newspapers.” – Head of Active Ownership, Asset Management Company 3

Second, the Dutch active ownership model favours long-term relationship building over short-term results:

“Our engagement successes in the last few years were about [...] making clear what was important for us, the intensity of the relationship, and this way you have a discussion with the Board of Directors as well. And then we finally saw some changes with regards to KPIs, for example. It’s a long way, but that’s fine. Of course, I would like to see changes within the next month, but it’s not realistic, that’s not the way it works.” – Senior PM Equities, Pension Fund Investment Manager 3

According to the interviews, a long-term relationship with portfolio companies is fostered when three conditions are met

1. Extensive due diligence

In-depth research and understanding the business of the company allows investors to have a productive dialogue with the companies and stimulate conversations on long-term topics. As one interviewee explains:

“We make a point of doing our homework and presenting to the board of the company how we view them. It can become a two-way discussion, rather than just the company sending information, which tends to be more short-term. That’s how we steer the dialogue on the long-term issues.” – Head of Focus Equities, Pension Fund Investment Manager 2

2. Long-term presence

Being a long-term shareholder and meeting the management on a regular basis provides the foundation for an ongoing productive dialogue.

3. Communication

Posing long-term, strategic questions to the management of the company and clearly communicating the investor’s priorities helps channel the discussion towards strategic questions rather than quarterly numbers.

“We speak to the top management of the companies we invest in quite regularly. Being helped by the fact that we’re a long-term buy-and-hold shareholder, so we are there the next year as well. In the end, they know what we find important. For example, if a company we invest in is thinking of doing an acquisition or an equity raise, typically we will discuss that to help them [make a decision] towards a specific alternative.” – Senior PM Equities, Pension Fund Investment Manager 3

An important tenet of active ownership is the emphasis on continuous engagement beyond voting the in the annual general meetings (AGMs). There is consensus

among interviewees that AGMs are the *outcome* of long-term collaboration, not the goal. Voting is often seen by investors as procedural, policy-driven, in contrast to engagement, which gives investors the opportunity to address their concerns and receive feedback from the company. Investors should strive to make their opinions known in advance of the AGMs, says one of the participants: “The voting should not be a surprise for the company.” (Senior PM Equities, Pension Fund Investment Manager 3)

As previously stated, several engagement topics were repeatedly flagged as essential in unlocking long-term creation of portfolio companies.

The first and the most commonly mentioned topic was *governance*. Specifically, remuneration of the top management and their incentive structures were singled out as the most important topic in the shareholder-company dialogue. A widely held conviction is that the managers respond to the incentives created for them. For example, if managers are remunerated based on the stock price appreciation or EPS, they will strive to achieve that outcome, often at the detriment of longer-term strategic goals. Therefore, it is important that managerial incentives are aligned with the company’s longer-term goals.

“The incentive structure is key. We want to see long-term incentive structures, not 12-month KPIs and bonuses. [...] You have schemes that only focus on EPS growth, which can be easily manipulated. You should focus on value creation and sustainability, and that will be more prevalent in the coming years.” – PM, Pension Fund Administrator 2

Two parameters of remuneration are typically emphasised by the shareholders: the KPIs and the time horizon of the incentives. The KPIs should be based on the metrics that reflect value creation by the business (e.g. economic value added), and should be paid out over several years, even if the manager leaves the company.

Another area where institutional investors can make a difference is encouraging companies to take up *integrated reporting*. Companies are increasingly reporting on their ESG metrics, particularly in the developed world, but only few report on the impact of their products and services. Encouraging companies to be more transparent on their ESG and impact performance will eventually lead to more consideration given to those factors by both companies and investors.

Finally, a third topic frequently mentioned by the interviewees is *strategy*. Asking probing long-term questions can make an investor a valuable “sparring partner” for the company’s management. It also vocalises the shareholder’s priorities:

“Both managers and trustees say that they are very influenced by the short-term gain of realising the expected EPS each quarter. It distracts [them] from the long term. Just being a counterbalance by saying that you don’t care about the earnings next quarter, you care about their value generation in the next decade—that already provides a counterbalance.” – Prin. Director Investment Strategy, Pension Fund Investment Manager 1

3.1.2.3. Large-Stake, Concentrated Portfolios

The interviews have provided strong evidence in favour of a relationship between concentrated portfolios and active ownership. Not only do the investors in our sample state that engagement is more important for concentrated portfolios, but investors also opt for concentrated portfolios **because** they enable meaningful engagement.

The primary reason why engagement (active ownership) becomes more important in running a concentrated portfolio is quite self-evident: The risks and rewards are more concentrated, and each portfolio company's performance has a material impact on the portfolio return.

Interestingly, many participants have pointed out that the relationship between portfolio concentration and engagement may run in the opposite direction. For them, concentrated portfolios are a tool to enable their active ownership approach.

"If you really want to do engagement very well, you can't do engagement with 7000 companies, not even with 400 companies—it's very difficult. That's why we run concentrated portfolios." – CIO, Asset Management Company 2

"We are concentrated because we want to be engaged, not the other way around." – Head of Focus Equities, Pension Fund Investment Manager 2

Active ownership pre-supposes extensive due diligence and regular discussions with the company (as outlined in the previous section). It becomes progressively more resource-intensive to engage with the investees as the number of stocks in the portfolio increases. Moreover, concentrated portfolios enable investors to take significant positions in their portfolio companies (5% stakes are common), providing the investors easier access to management and more influence on the company's strategic trajectory. Hence, concentrated portfolios offer a favourable setup for long-term value creation.

However, not every institutional investor can afford to hold a substantial percentage of portfolio companies' shares, particularly when investing in large-caps. Therefore, collaboration with other institutional investors becomes crucial.

3.1.2.4. Collaboration

Joining forces with other investors when engaging with a company can be helpful for two reasons. First, it can dramatically increase the salience of the message. When investors collectively engage with a company due to a shared concern, the management is more likely to recognise the importance of the issue and act on it. Second, the company can engage in a dialogue with one representative rather than with many individual shareholders, which spares the resources of both the company and its investors.

"Also, when engaging with Dutch companies, the collaboration within Eumedion is also very helpful. It's also often appreciated by the companies that they do not have one investor after the other talking about the same issue, but they join forces." – Head of Active Ownership, Asset Management Company 3

In the Netherlands, investor collaborations are mainly carried out through the Eumedion Corporate Governance Forum.

3.1.3.LTVC Challenges

Previous section explored the current practices related to long-term value creation by the Dutch institutional investors. However, many roadblocks remain on the path to long-term cooperation between investors and corporations.

There are both *internal* and *external* challenges. Many participants have stated that asset management companies need to evolve internally in order to facilitate a long-term focus. Overreliance on benchmarks, coupled with short-term performance evaluation, has given rise to a narrow focus on beating the market on a monthly or quarterly basis. Finally, investment decision-making in many organisations is decoupled from ESG analysis. The ESG department is seen as a support function and often does not speak directly with top management of portfolio companies, nor does it have a say in the allocation of funds.

Externally, the lack of alignment between institutional investors and their clients means that the asset managers often have little leeway to invest for the long term. Another issue is the difficulty of defining sustainability. Some progress has been made on that front: For example, the UN SDGs offer a typology of the world's biggest sustainability challenges. However, sustainability is multifaceted and often comes with trade-offs between different goals. Furthermore, available ESG data has many shortcomings which limit its usability in investment decision-making. The barriers to long-term value creation are summarised in *Table 4* and *Table 5*.

LTVC challenge	Benchmark orientation	Short-term performance evaluation and incentives	Lack of integrated thinking
Explanation	Asset managers groomed in the neoclassical theory of finance rely on passive investing with a strong benchmark orientation.	Frequent performance evaluation and short-term incentives for asset managers result in the pursuit of short-term performance.	The investment decision making is decoupled from ESG. PMs and ESG professionals have different views on the same subject.

Key quotes	<p>“The biggest issue not only in the academic world, but in the finance world in general: We have all been trained in the efficient market paradigm. [...] The savers have long-term goals; the companies need long-term funds. Why don't they get it in the way that the capital system should work? That's because in the middle, benchmarks have been created.” CIO, Asset Management Company 2</p> <p>“We are still very much married to the neoclassical investment theory which says that the benchmark is the best recipe for investing. [...] As long as you see the performance of the markets as the ultimate benchmark, you will not get away from comparing yourself to that benchmark. But if you look at the benchmark, it is flawed in many ways. Prin. Director Investment Strategy, Pension Fund Investment Manager</p>	<p>“Investors have to perform on a 12-month horizon. That just makes people very short-term oriented. They are afraid of missing their performance targets in the short run.” Senior PM Impact Investing, Asset Management Company 1</p> <p>“As you select an investment manager to have a long-term investing scheme, how would you evaluate them? Typically, it's short-term because if he's not a good guy to invest your client's money, you would switch to another one.” Senior PM Equities, Pension Fund Asset Manager 3</p> <p>“A lot of PMs get fired if they underperform for 2 years. Of course, you can't have that. Certain managers can be very good, but they had a difficult time over the last 5 years [because of the concentration of outperformance in a</p>	<p><i>“[Typically], ESG people don't know about finance, and the finance people probably don't know that much about ESG. When ESG people talk about that stuff with other ESG people, and that sort of circles in their own environment, you have to be lucky if some of that reaches top management.” Head of Equities, Pension Fund Investment Manager 1</i></p> <p><i>“It is important to have one company-wide view on the matters, rather than PMs saying one thing and the ESG people different things, which is a complaint from companies.” Head of Focus Equities, Pension Fund Investment Manager 2</i></p>
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LTVC challenge	Lack of alignment within investment chains	Lack of sustainability standards
Explanation	Asset managers can be long-term oriented only if their clients (asset owners) are long-term oriented.	Companies do not always report on material issues; the ESG ratings are biased. Many SDGs are not considered investable at present.
Key quotes	<p><i>“There are agency issues across the entire chain. And because of that, as you go further down the chain, your horizon gets shorter because you will have outsourced certain tasks to others that you need to monitor, and to keep within the boundaries of what you agree on. That leads to less trust in the system and more rules. And that tends to focus on more shorter-term elements than necessary and productive for a long-term investor.”</i> Head of Equities, Pension Fund Investment Manager 1</p>	<p><i>“People are talking about long-term value creation. But you need to cooperate to converge to some kind of standardisation of what that means.”</i> CIO, Asset Management Company 2</p> <p><i>“Sustainability is so multi-faceted. You can focus on carbon footprint of your operations, gender diversity of your workforce, human rights abuses in your supply chain, corruption... If you look at the ESG ratings, they consist of so many different elements. You may implement some of those factors at the expense of the other.”</i> PM, Pension Fund Administrator 2</p> <p>“The data is huge problem. Another one is a lack of standards on this. In financial analysis, it is quite clear how to measure sales, losses, etc. Of course, you can still tweak it a little bit, but there are definitions around that. There is a lack of standards, a lot of confusion, and as a result of that, a lack of awareness.” Senior PM Impact Investing, Asset Management Company 1</p>

Table 5. LTVC Challenges (Institutional Investors) (2)

3.1.3.1. Benchmark Orientation

In the world of asset management, Markovitz' modern portfolio theory (MPT), rooted in the efficient market hypothesis, reigns supreme. The assumption that all relevant information is incorporated in the stock prices, and that investors cannot beat the market systematically, has led to the substantial rise in passive investing in recent years, partially displacing active management strategies. The Bank of International Settlements (2018) reports that 20% of global assets under management were invested in passive funds in 2017, compared to only 8% in 2007.

A key notion within passive investing is *benchmarking*, whereby the asset manager's performance is compared to that of a market- or a segment-tracking index. This global phenomenon is also reflected in the Dutch asset management industry. Most of the investors are evaluated against a benchmark index. Underperformance vis-à-vis the benchmark poses significant career risks for investment managers, leading many of them to retreat to passive or quasi-passive strategies.

"These pension fund managers... they just want to play it safe, ideally. If you buy passive, you have low costs, and your performance is very predictable, at least on a relative basis. [...] If the benchmark crashes because of the carbon price, then you're gone as well. However, they feel safe all their peers will also [underperform] because they do exactly the same thing. [...] They [fund managers] take the benchmark, and they take each other as a benchmark, rather than taking the real world as a benchmark." – Senior PM Impact Investing, Asset Management Company 1

Hence, overreliance on benchmarks further contributes to the growth of passive investing. The prevalence of efficient market thinking has led to an environment where relative performance matters more than absolute performance. In that sense, concentrated portfolios clash with the prevailing mindset because they introduce (by definition) a larger tracking error than the passive portfolio. Commenting on that, one interviewee reflects:

"The problem with a concentrated portfolio if you have a very strong benchmark orientation, which is still the case for most institutional investors, is that it will lead to a larger tracking error (because of the fact that you have a condensed portfolio)". – Head of Equities, Pension Fund Investment Manager 1

The current industry setup, therefore, implicitly deters asset managers from investing in high-stake concentrated portfolios. Hence, excessive benchmark orientation fails to incentivise skilled investors to direct the flow of capital to its most productive uses. Instead, investors are rewarded for "spreading their bets".

3.1.3.2. Short-Term Performance Evaluation and Incentives

The previous section discussed how benchmark orientation has contributed to the growth of passive investing, thereby swaying institutional investors away from

performing their original role in the capital markets. Here, we explore how benchmarks reinforce a short-term focus when paired with frequent performance evaluation, and why the current system is fundamentally incompatible with long-term investing.

The interviews have revealed that the asset management industry is largely focused on short-term performance and enforces this focus with a powerful system of incentives. One interviewee recounted his time as a portfolio manager at a major Dutch financial institution in the following way:

“We got a spreadsheet daily specifying our out-performance on a daily basis, we were paid by the year, and so on... And if you said: “Come on, buy me some of this stock, it is a good company”, but the profits were a little bit below expectations because the dollar had dropped, they wouldn’t do it...” – PM, Pension Fund Administrator 2

This excerpt demonstrates how a short-term focus translates into concrete decision making within financial institutions. Frequent benchmarking—originally designed to make investment performance understandable and transparent—has evolved to encourage short-term thinking. When asset managers are evaluated on a quarterly or a yearly basis, in the absence of counterbalances, they are compelled to prioritise short-term returns over long-term value creation.

This poses a significant challenge for long-term investors, who must conform to the same set of performance standards as their short-term peers:

“We have shareholders in our funds, and we have to perform on a quarterly, annual, three-year basis as well. That’s always the difficulty: Investing in companies for the long term, on the one hand, but, on the other hand, having short-term shareholders as well, who have to show positive returns to their policy holders or whoever their clients are.” – Head of Active Ownership, Asset Management Company 3

“When you have a truly long-term product, then the question is: Do you measure performance on a monthly, weekly, daily basis—you name it?” – Senior PM Equities, Pension Fund Investment Manager 3

A second challenge is that the benchmark, at least in the short-term, is a poor proxy for long-term value creation. For short-term investors, whose goal **is** to beat the market, taking the market index as the yardstick is logical. However, for long-term investors, the returns of a market index are a flawed performance measure:

“As long as you see the performance of the markets as the ultimate benchmark, you will not get away from comparing yourself to that benchmark. But if you look at the benchmark, it is flawed in many ways. There are all kinds of concentration, e.g. 20% in the financial sector, etc. You need to re-think what you are trying to achieve with the return-generating part of your portfolio, and that might well be an absolute return.” – Prin. Director Investment Strategy, Pension Fund Investment Manager 1

The benchmark does not cater to the needs of long-term investors, which results in a clash of incentives where sustainability is pitted against performance:

“We had huge discussions to exclude tobacco at our firm. The portfolio managers said: “No, but then I cannot keep up with the staples index” – Senior PM Impact Investing, Asset Management Company 1

In summary, current incentive structures in the asset management industry generate a focus on the short-term performance. In the present environment, long-term investors must swim against the tide, balancing short-term performance measurement with their long-term investment objectives.

3.1.3.3.Lack of Integrated Thinking

In most asset management companies, investment decision making and ESG analysis are segregated. Portfolio managers are responsible for selecting the best investment cases, whereas ESG professionals engage with the companies on sustainability matters.

Such separation of duties is problematic in at least three aspects. First, ESG analysis is not fully incorporated in the stock selection process. Second, since portfolio managers usually engage with companies more often, ESG topics may be de-emphasised compared to the financial topics. Third, portfolio managers and ESG/SRI professionals focus on different issues in shareholder engagement, causing confusion about the investor’s priorities.

3.1.3.4.Lack of Alignment Within Investment Chains

A common problem faced by long-term investors is the difficulty of reconciling a long-term investment approach with the expectations of the asset owners (clients).

Although asset owners demonstrate a growing appetite for sustainability-focused portfolios, they often expect a conventional performance profile from such portfolios, evaluated using the same risk metrics and reference indices as the other portfolios. Because many asset owners still subscribe to the efficient markets thinking, both underperformance and (perhaps more surprisingly) outperformance become a concern for them:

“You cannot be a true long-term investor if your client does not understand what you are doing. It might happen very easily that you underperform for 2 years on the way to good, predictable long-term performance. If you agree on a 5+ year horizon, and after 2 years your client says: “It doesn’t work, we’re sacking you anyway”, it’s the end of the game.” –Head of Equities, Pension Fund Investment Manager 1

“We notice that the clients still look at the benchmark, and we show that last year our fund did 17.5%, and the index did 9%, so we outperformed it by almost 9%. Of course, if you underperform, it’s bad, but if you outperform by a lot, like this, they also get suspicious.” – Senior PM Impact Investing, Asset Management Company 1

The frequent lack of understanding of long-term strategies on the client side highlights the need for communication between asset owners and asset managers,

aligning their approaches and jointly devising alternative metrics for performance evaluation.

3.1.3.5.Lack of Sustainability Standards

The multifaceted nature of sustainability leads to three obstacles to long-term value creation. First, it is difficult to codify sustainability. Hence, there is a lack of standardisation in the field. Second, the complexity of sustainability challenges gives rise to trade-offs between different aspects of sustainability. Third, material sustainability issues (and solutions) are often industry- or even company-specific and therefore require in-depth understanding from the investor to be investable/engageable.

The lack of standardisation feeds into the problem of limited applicability of current ESG/sustainability data for investment decision-making. Among the investors interviewed, scepticism about the quality of sustainability data prevails for several reasons. First, the databases are based on reporting data, so ESG ratings favour large, established companies with the resources to report extensively on ESG. Second, because the input data is provided by the companies themselves, there are concerns about its objectivity. Third, sustainability ratings do not consider the product impact (for example, a tobacco company might have a high ESG rating). Therefore, although ESG ratings incorporate a multitude of ESG factors, they may not reflect material aspects of a company's sustainability performance. As summarised by one of the participants:

"[ESG ratings] look at 50 factors instead of focusing on those that are most material. [...] In many cases, you have to do fundamental analysis to really understand the company. Of course, later you can codify that. But those codifications without even trying to do a fundamental analysis—that creates an appearance of precision while it's not there." – Senior PM Impact Investing, Asset Management Company 1

Although those ratings might provide a useful starting point, they cannot substitute in-depth company analysis and bottom-up stock selection for long-term oriented investors. The data has not evolved to the point of permitting viable quantitative investing solutions to develop, therefore, active ownership remains the only feasible investing approach for long-term value creation.

3.1.4.Solutions for LTVC

Although there are undoubtedly many challenges in the field of long-term creation, the interviews have also helped to identify a path forward for long-term investors. Four potential solutions, all corresponding to different challenges of LTVC, are covered in this section.

First and foremost, long-term and holistic performance measurement should align the incentives of portfolio managers with long-term value creation. Second, performance transparency and in-depth discussions with the asset owners are required to create alignment within the investment chain. Third, asset managers should choose a priority area within sustainability and specialise in it to cut through

the complexity. Fourth, portfolio managers should take the lead on ESG/impact engagement, with the ESG department serving as the knowledge centre.

These solutions are presented in *Table 6* and *Table 7*.

Solution	Long-term holistic performance measurement	Creating client alignment
Explanation	Performance metrics should be long-term, and they should include non-financial factors to align the portfolio manager’s goals with long-term value creation.	Discussing long-term objectives with clients at a qualitative level and educating them on the possible performance profiles.
Key quotes	“On the one hand, you have performance, on the other hand you’ve got the risk metrics. These are typically old-school as well. People talk about tracking error, for example, and that’s also on a relative basis. When you are truly a long-term investor, then the index is irrelevant. And that needs to change as well. To summarise, it’s all about culture, and letting old-school thinking go away and replace it by really long-term metrics. And that’s not an easy thing.” Senior PM Equities, Pension Fund Investment Manager 3	“We can’t get rid of all of the benchmarks today because our clients still give us benchmarks. First of all, we try to get to an agreement with the client that this is only a reference index for the short-term, and that we need to have time, we need to have a long-term perspective and mandate. And that we have the same investment philosophy and beliefs. If the client hands us money, do we have the same [philosophy]? That’s a very important part. It takes sometimes up to 6 months to get to an alignment on what we want to achieve together.” CIO, Asset Management Company 2

Table 6. Solutions (Institutional Investors) (1)

Solution	Specialisation	Speaking with “one voice”
Explanation	A focused approach to sustainability, motivated by expertise, value drivers, or client profiles.	An integrated engagement process where portfolio managers speak to companies about financial performance, strategy, and sustainability.
Key quotes	<p>“As an asset owner or investment manager, you should have some focus areas, focus topics. Engaging on everything that comes by is impossible. You have to find something that’s important to <i>you</i>. Maybe even the themes that you play in the portfolio—climate or other themes—if you find things that you work on in your portfolio, it is logical to try to engage on those themes, and not try to engage on everything that’s possibly engageable.” CIO, Pension Fund Administrator 1</p>	<p>“... the PMs are the people who need to engage. Not ESG analysts somewhere in the building. But it’s the PM that call the shots, who really have the influence to talk to the CFO, CEO of a company. And put things on the table that they think are important. Not only financial or strategy topics, but ESG topics as well.” CIO, Asset Management Company 2</p>

Table 7. Solutions (Institutional Investors) (2)

3.1.4.1. Long-Term Holistic Performance Measurement

Benchmarking serves an important function in the financial markets, contributing to performance transparency and comparability. Nonetheless, it is widely recognised by investors that benchmarking in its current form is not compatible with long-term investing as it amplifies the focus on short-term financial performance. The benchmark needs to evolve with the evolving goals of long-term investing.

First, asset managers with long-term mandates should be evaluated over a longer horizon. Currently, performance evaluation still happens on a monthly, quarterly, or annual basis. Although performance monitoring is undeniably useful, short-term performance must be de-emphasised in long-term mandates. Instead, multi-year performance targets should be set. Otherwise, short-term underperformance may lead to erroneous decision making. The underlying dilemma was highlighted by one of the participants:

“As you select a specific investment manager to have a long-term investing scheme, how would you evaluate them? Typically, it’s short-term because if he’s not a good guy to invest your client’s money, you would switch to

another one. That's sort of the dilemma." – Senior PM Equities, Pension Fund Investment Manager 3

Furthermore, the composition of the benchmark should create a level playing field for long-term investors. An asset manager's long-term portfolio can be structurally different from the index, creating material differences in short-term performance. For example, a long-term investor may exclude certain industries with significant negative impact on the environment or the society from their portfolio, with the rationale those companies will underperform in the long run. However, if the benchmark still includes those companies, it affects the asset manager's incentives. Coming back to the tobacco example from earlier:

"We had huge discussions to exclude tobacco at our firm. The portfolio managers said: "No, but then I cannot keep up with the staples index". But once you change the benchmark and exclude those stocks from the benchmark, then they are fine. Because it's not in the benchmark anymore." – Senior PM Impact Investing, Asset Management Company 1

Finally, benchmarking must include alternative ways of measuring value creation. Non-financial performance targets should be introduced alongside financial benchmarks. If an asset manager is running an ESG/impact-focused portfolio, their performance has to be evaluated on those metrics. Combined with multi-year financial benchmarks, ESG/impact targets form a system of incentives that align the asset manager's self-interest with long-term performance of their portfolio:

"You can give PMs certain targets on ESG, too. The best solution to integrating sustainability in investments is just being long-term, and then it is in your own interest to have a high degree of attention to ESG, impact, and solutions. That's the only feasible way to integrate sustainability in investing. Not forcing it upon people." – PM, Pension Fund Administrator 2

In summary, careful thinking must go into designing the benchmark that truly reflects an investor's portfolio (e.g. excluding certain "sin" stocks from the benchmark). Performance measurement should be holistic (benchmarking needs to incorporate non-financial metrics tied to ESG and impact), and the benchmark has to be longer-term (e.g. yearly instead of monthly/quarterly; a multiyear benchmark).

3.1.4.2. Creating Client Alignment

To implement the incentive system for long-term asset managers described above, client alignment must be created. While some asset managers are able to attract sustainability-minded clients, other asset managers must use their existing client relationships to make the case for sustainability investing.

The interviews have revealed that the process of aligning expectations with asset owners is successful when the discussion integrates quantitative and qualitative aspects of investing. Changing performance metrics does not lead to a transition to long-term investing unless it is accompanied by a mindset change. That involves asset managers and asset owners working together to re-evaluate their investing goals.

“I invest in corporates long-term. That would mean that it is the same way I judge corporates: It’s not about their quarterly earnings, and if they are bad, we sell out—No, we invest in the corporates for the long-term. The same structure applies to somebody’s [evaluating] us from the long term. It’s much more about our thinking, our philosophy, do we agree on that? What is their incentive structure? It’s much more qualitative than quantitative. [...] It’s based, at the start, on the drivers (incentives) and the asset manager’s philosophy: How do they adopt long-term thinking? Which companies do they select?” – Senior PM Equities, Pension Fund Investment Manager 3

Only after alignment has been created on the overall qualitative objectives, quantitative metrics can be introduced to supplement them. Nevertheless, transitioning from the current state of the asset management industry requires a big cultural shift which will take substantial time and effort to accomplish. It is a gradual process that requires educating the client on the possible performance profile, breaking down performance to show the underlying drivers (by region, industry, etc.), and making non-financial metrics an integral part of the overall performance evaluation.

3.1.4.3. Specialisation

Sustainability is complex, and one asset management company cannot possibly specialise in all sustainability-related topics. Therefore, investment managers must narrow down their sustainability focus based on three parameters: existing expertise, beliefs about value creation, and client profile.

The accumulated *sustainability expertise* within asset management firms varies, and it may be beneficial for asset managers to focus on the areas which cater to their strengths. A governance-focused investor with a portfolio of small-cap investments explains:

“We have always been very active on the governance and being a long-term engaged shareholder with the companies that we invest in. [...] We focus only on a certain area, on the less efficient part of capital markets. We don’t do everything. We only do those areas where we think we can add value from a long-term perspective for our clients.” – CIO, Asset Management Company 2

Some investors have approached specialisation from a different angle, starting by defining their *beliefs about long-term value creation* and translating them into an investment strategy. An investor in innovation explains:

“We are looking for companies that are very innovative because if you are very innovative you can maximise all three [financial, social, and environmental returns]: You can provide a solution that is valuable to society, and also valuable to your customers, and as a result, to the shareholders, because the clients pay for it.” – Senior PM Impact Investing, Asset Management Company 1

Finally, *client profiles* may also suggest which areas of sustainability may become a priority for the investor, particularly for asset managers catering to one or several large clients. For example, PGGM, a pension fund asset manager in the

Netherlands, focuses on 4 topics in its “Investing in solutions” portfolio: climate change, water scarcity, food security, and access to healthcare (PGGM, 2018). These topics were chosen in consultation with PGGM’s largest client, PFZW, a pension fund for the healthcare sector employees. Investing in topics that are relevant for the client helps to create alignment around sustainability objectives.

One caveat to the notion of specialisation is that a focused approach must be balanced with some degree of diversification to avoid excessive risks:

“If you focus on just 1 or 2 SDG, you tend to get a very risk-concentrated portfolio. So, lots of people have bad memories from 2007-2008, when all those water and renewal energy funds crashed, and we want to avoid that, so we invest in People, Planet, Prosperity, not just Planet.” – Senior PM Impact Investing, Asset Management Company 1

3.1.4.4. Speaking with “One Voice”

Speaking with “one voice” is an expression borrowed from one of the interviews. It means having ESG and sustainability concerns at the core of the engagement process and expressing one company-wide view on sustainability.

That requires portfolio managers to become well-versed in sustainability matters and lead the engagement on ESG and impact, supported by their ESG colleagues. As PMs are the investment decision makers, that approach will send a strong message to the portfolio companies about the centrality of sustainability to the asset manager.

Several asset management firms in the Netherlands operate according to that principle, integrating the financial analysis with the ESG due diligence. They can lead the industry by example, showing that holistic investment analysis and engagement is feasible and impactful:

“We integrate the two sides, and that helps to be taken seriously by the management of companies: They know that the ESG people only talk about ESG with them, so the ESG people from the investor’s side will probably talk to the ESG people from the company. In our case, the general analyst talks to the top management of the company about all subjects. It also means that we get things done to some extent on ESG subjects, and definitely on impact. [...] I think our impact on companies is much larger because of the model that we have.” – Head of Equities, Pension Fund Investment Manager 1

3.2. Interviews with Corporate Managers

3.2.1. Defining LTVC

The interviews with corporate managers were structured to mirror the interviews with the institutional investors. The goal was to facilitate comparisons across the two groups of respondents and see where their views converge and where they may be different—and importantly, analyse which factors may account for the differences.

Hence, in the beginning of the interview, corporate managers were asked to elaborate on the meaning of long-term value creation for the company and its industry. Like institutional investors, corporate managers exhibited significant differences in the factors they included in long-term value creation.

Some definitions were centred on the financial returns generated by the business, whereas others emphasised stakeholder value creation and innovation. It must be noted, however, that the sample of corporate managers is heterogeneous in terms of the industries represented and the functions within the company (legal, financial, investor relations, etc.), so the differences in their responses are at least partially a product of their different focal areas within the company. For example, a legal professional emphasised the role of litigation risk in long-term value creation, whereas a CFO described value creation primarily in financial terms. Such answers should be treated as complementary rather than mutually exclusive or contradictory. Generally, investors relations professionals tended to adopt a broad perspective in defining long-term value creation, so their answers can be treated as complete on a standalone basis.

Definitions of the long term, defined by the longest time horizon considered in strategy formulation of the company, varied from 3-4 to 10 years. However, the participants unanimously admitted that it is difficult to create a strategy beyond the 5-year horizon, and that the strategic outlook depends on the nature of the business, for example, its stage in the lifecycle and competitive dynamics.

Apart from financial returns, three interconnected facets of long-term value creation were identified: catering to customer needs, delivering innovation, and creating value for stakeholders. They are summarised in Table 8 and Table 9.

LTVC component	Financial returns	Catering to customer needs
Explanation	Long-term return on invested capital higher than the cost of capital. Although profitability metrics were more common, share price appreciation and TSR (total shareholder return) were also mentioned.	A business cannot succeed without attracting and retaining customers. Therefore, creating marketable value propositions and being tuned to customer needs is a cornerstone of value creation.
Key quotes	<p>“Our view is that the cost of equity is 10% across the cycle. So long-term value creation from a shareholder perspective is very plainly, anything that yields a return on equity of >10%. [...] We look at anything that yields a return on invested capital (ROIC) over 10%, and that creates value for our shareholders. To get to a ROIC of >10%, you need to do a lot of things right. Long-term and sustainable means that you want to have a business that is able to run above the cost of capital for a long period of time.” CFO, Company 5</p> <p>“It’s easy to describe what creating value for a shareholder would look like, for example, with TSR or ROIC.” Head of IR, Company 8</p>	<p>“We create value for our customers. That’s our focus, and the rest will follow.” Head of IR Europe, Company 7</p> <p>“We think that long-term value creation comes from selling to consumers what consumers want.” Head of IR, Company 8</p> <p>“What you have to do [as a corporate] is stay close to the customer, and the customer is changing. And it’s a strong argument, also to the investors. You should formulate a strategy to cater to the customers of tomorrow.” Chairman Supervisory Board (Former), Company 1</p>

Table 8. LTVC Components (1)

LTVC component	Innovation	Stakeholder approach
Explanation	Innovation as a value driver that helps to deliver continuously strong financial performance, secure a strong market position, and generate solutions that lead to a better stakeholder impact.	To be successful long-term, a company needs to create value for its stakeholders, sometimes reconciling their conflicting interests.
Key quotes	<p><i>“We are about technology and innovation, and that’s the opportunity we sell to our investors”. Head of IR Europe, Company 7</i></p> <p><i>“We have more and more clients saying: Can you take care of our mobility in the most efficient way, also in the view of society? If that’s the question, you go to as low pollution as you can get at the lowest price possible through digitalisation.” Chairman Supervisory Board (Former), Company 1</i></p>	<p>“If you talk about long-term value, you have to look to your stakeholders. Because you cannot have one definition. Sometimes, the definitions of long-term value between different stakeholders are conflicting. That’s the most difficult thing.” Chairman Supervisory Board (Former), Company 1</p>

Table 9. LTVC Components (2)

3.2.2. Instruments for LTVC

When asked about the role of corporates in the shift to long-term value creation, participants generally agreed that corporates have an important role to play in the process. There are three main tools that corporations are using to promote long-term value creation: strategic decision-making, long-term performance incentives, and allocating capital to long-term initiatives. Those tools are presented in *Table 10*.

LTV instrument	Strategic decision-making	Long-term performance incentives	Capital allocation decisions
Explanation	Formulating a long-term strategy and executing it involves prioritising long-term goals over quarterly numbers and accepting performance fluctuations.	To focus the management on running the business for the long term, it is important to align their performance incentives with the long-term value creation. Short-term performance targets (yearly) should be aligned with long-term goals.	Investing in research and development, capital expenditure, marketing, and other areas that generate long-term payoffs.

Key quotes

“You need to decide in terms of your identity: “What company am I? What company do I want to be?”. That doesn’t have a time horizon. Cognizant of the fact that you can’t govern the future for 20 years ahead, but you can make this decision in terms of where you are today and where you think the company should be, barring any fundamental changes in the market.” Member of the Executive Committee (Former), Company 2

“In 2008-2009, we could have cut down on R&D because we were losing money, but we decided to continue to invest in our R&D programme because we thought the business would come back. Our competitors cut back in the meanwhile, and we could grow our market share afterwards because

“For our board, the majority [of incentives] is based on the 3-year ROIC with a 2-year lock-up period—essentially, a 5-year period before they can sell their shares. We also use TSR, where we compare the performance of our company to the performance of the industry index. That’s for the board and 300-400 managers worldwide. Management is also rewarded for ESG performance.” Head of IR Europe, Company 7

“We invest significantly in the future. We invest in new products, in R&D. We also invest in CAPEX to accommodate our growth. We also invest strategically in other companies if that helps the company fulfil its business ambitions.” Head of IR Europe, Company 7

“It’s about your investment policy: where you put your money. The amount of money you invest in R&D, especially fundamental R&D. On the marketing side, when you are trying to build a certain market, an awareness. Big re-branding exercises, that takes a certain amount of time. Investments that have a longer pay-out ratio.” Member of the Executive Committee (Former), Company 2

Table 10. LTVC Instruments

3.2.2.1.Strategic Decision-Making

High-level decisions in the company must be driven by strategic considerations rather than by short-term market dynamics, such as commodity prices or currency fluctuations. For a company with a clearly articulated vision of its long-term goals, it is easier to stay focused on its priorities and continue to pursue its strategy when market fluctuations give rise to short-term financial pressures.

3.2.2.2.Long-Term Performance Incentives

The importance of long-term incentives for investment managers was elaborated on earlier. Generally, the same logic applies to the performance incentives for corporate managers: Incentives need to be designed in a way that aligns the managers' self-interest with the long-term success of the company.

Overall, performance incentives within Dutch corporates are more in line with long-term value creation than those in the asset management industry. Every company in the sample has a balance of short-term and long-term performance targets; most also have ESG-related performance goals. Share vesting is widely used as a mechanism to align the interests of managers with long-term value creation.

3.2.2.3.Capital Allocation Decisions

Capital allocation decisions are a powerful way to enact a company's strategy. Typically, long-term investments are not only capital intensive, but they also have long payback periods (e.g. a production facility) or uncertain benefits (e.g. fundamental research). Therefore, such decisions need to correspond to the company's long-term strategy, and managers need to be incentivised to invest in long-term initiatives rather than maximising short-term financial returns.

3.2.3.LTVC Challenges

Investors relations professionals approached the discussion of the difficulties in long-term value creation on the side of caution. As their role requires them to represent the company, it is understandable that they may have felt compelled to downplay any controversial subjects. However, as IR professionals represented over half of the corporate managers sample, the number of insights generated on the "pain points" in long-term value creation is limited.

Nevertheless, three common threads were identified in the interviews: short-term pressure from the financial community, customer adoption risk, and conflicting stakeholder interests. They are shown in *Table 11*.

LTV challenge	Short-term financial pressure	Customer adoption risk	Conflicting stakeholder interests
Explanation	When external developments hurt company performance, there is pressure from the financial community to make sub-optimal financial decisions to meet the targets.	If a sustainable product fails to gain traction in the market, the company risks losing its market share to competitors; it must therefore continue offering the inferior alternative.	Different stakeholders may have conflicting priorities. Most frequently, that manifests itself in the trade-off between shareholder returns and the needs of society/environment.

Key quotes

"We are exposed to the operations in emerging markets: Brazil, Nigeria, Vietnam. If these currencies vs. the euro are suffering, our financial results suffer. And people [financial analysts] turn to us and say: "Why don't you spend less elsewhere?". Why should we do things differently in Europe because we need to compensate our poor financial results in Brazil? We won't reduce commercial investments in Europe because the Brazilian currency fell." IR Director, Company 6

"Unlisted companies have more time to look at long-term value. Listed companies must report what they are doing, and investors are dissatisfied if the profits go down. So you look deep into your pockets to find that extra profit, and mostly that's at the cost of the investments."
Chairman Supervisory Board (Former),
Company 1

"Concentrated liquids (softeners, detergents) are much more environmentally friendly, and we try to convert consumers to those. But if they decide that they don't want to buy it, what do you do? Do you find yourself being thrown out of the market, or do you flip back to having the non-concentrate? We would see it as a failure to convert, but sometimes you have to make those choices." Head of IR, Company 8

"For instance, you have a product on the market that has a much better [lower] footprint, but it's much more expensive. You also have a cheaper, more pollutive alternative. You could say: "We'll stop producing the latter product". That would have a very detrimental impact on your margin. But there's a caveat: your customers may buy another company's product." Member of the Executive Committee (Former), Company 2

"Then you have society, sometimes represented by the government. They say: "Long-term value is that you solve the problem of mobility in the society without harming the environment." But the shareholders will say: "That's all fine, you have to offer mobility in a digitalised world, I understand that, but not at my cost of capital".
Chairman Supervisory Board (Former),
Company 1

Table 11. LTVC Challenges

3.2.4. Solutions for LTVC

Finally, several solutions for long-term value creation have been identified to address the short-term pressures faced by companies. First, attracting a long-term shareholder base helps the company to ensure that its shareholders are aligned with the company's value creation strategy and are less susceptible to concerns over short-term performance fluctuations. The companies in the sample achieve that in two ways: by proactively initiating talks with long-term shareholders and by being transparent about their long-term orientation in their general communication. Second, the company can steer the discussion towards the long term by issuing long-term strategic guidance and refraining from quarterly reporting. Increasingly, Dutch companies are opting for quarterly trading updates instead of issuing full reports, which helps to de-emphasise quarterly performance.

The two strategies are presented in *Table 12*.

Solution	Long-term shareholder base	Strategic guidance
Explanation	Long-term shareholders are more likely to understand the fundamentals of the business and support the company's long-term initiatives.	By giving qualitative long-term guidance and using ranges instead of hard targets, the company can share information about its strategy and initiate a discussion of long-term topics.

Key quotes

"For example, we don't sell certain products in China because China requires animal testing, and we don't do that. That's the trade-off we're making. A hedge might find that less attractive and therefore invest in us less. Whereas a very long-term investor would approve of the fact that we are making that trade-off.

We are making it very clear what we are about." *Head of IR, Company 8*

"If you are a permanent shareholder, the moment of purchase and the sale of the shares becomes a lot less relevant. You look at the appreciation of the value of the business and the dividends that you receive." IR Director, Company 6

"Not very long ago, we moved from quarterly reporting to half-year reporting with trading updates in Q1 and Q3. Some investors were concerned at the start, but now it is a non-issue." IR Director, Company 6

"We have long-term guidance for our growth level, which we think should be between 3% and 5%. We expect to be within that range most of the time, not all the time, not every quarter. We don't give top-line guidance on the year. On the margin, we said in 2017 that our 2020 goal was to achieve an underlying operating margin of 20%. That's all that we've put out there in terms of guidance." Head of IR, Company 8

Table 12. Solutions

4. Discussion

The article investigates the challenges and best practices of long-term value creation by the Dutch institutional investors using semi-structured interviews. The paper aims to contribute to the literature on long-term value creation by concurrently analysing two parties in the investment process (investors and corporates) and examining processes and the underlying rationale behind their decisions. 21 participants were recruited for the study, representing a diverse sample of institutional investors and corporate managers in the Netherlands.

The interviews revealed five primary challenges for long-term value creation by the institutional investors in the Netherlands. The overreliance on benchmarks, short-term performance evaluation, and the lack of alignment within the investment chains on the long-term goals creates an environment that favours passive investing. Additionally, due to the complexity of sustainability and poor data quality, it is difficult for investors to create strategies to identify and invest in the most sustainable companies. Finally, in many organisations, investment decisions are decoupled from ESG engagement, evidencing the lack of integrated thinking. The interviews demonstrate that actively managed concentrated portfolios are the only feasible approach to long-term value creation in investing under the current circumstances.

For corporate managers, the main difficulties of long-term value creation are the short-term pressures from the financial industry, the competitive risks associated with introducing sustainable products, and reconciling the conflicting priorities of various stakeholders. The research underscores the need for more long-term shareholders that could lead a long-term strategic conversation with the corporations, instilling a healthy balance between of short-term and long-term perspectives.

Appendix I. Interview Sample Characteristics



