GIC × FCLTGLOBAL
FOCUSING CAPITAL ON THE LONG TERM

Taking Action to Navigate a World in Transition

Balancing Resilience & Agility to Deliver Long-term Performance

GIC Insights 2022

15 November

FOREWORD

Established in 2016, GIC Insights is GIC's annual thought leadership event that gathers prominent business leaders from across the globe to deliberate over long-term issues pertinent to the international business and investment community.

The need for such a forum has become especially apparent in recent years. Companies are facing disruptions on many fronts including changes in the macroeconomic regime, new geopolitical realities, rapid technological change, and rising pressure to address the climate crisis, among other critical issues. As a result, companies are trying to build resilience into their operations.

The issues businesses are being confronted with must be assessed both individually and as part of a larger paradigm shift. Being able to withstand or adapt to disruption and deliver strong performance in parallel will be critical in the years ahead. Businesses will need to truly demonstrate resilience in order to thrive over the long term.

While these will not be easy problems to solve, we believe that a frank and direct discussion among global business leaders is one of the few ways to truly move the needle on building resilience at scale.

In that spirit, GIC partnered with FCLTGlobal to bring its unique roundtable meeting format to GIC Insights 2022. C-suite participants for this session, representing leading companies, asset owners, and asset managers around the world, shared how they are keeping their organisations agile to today's challenges, and the obstacles they are encountering as they do so. Platforms such as these where global leaders can exchange best practices and lessons learnt will be critical in finding answers that will stand the test of time.

Our thanks go to everyone who was able to participate in this important conversation. The insights on the pages that follow encapsulate the key takeaways we heard in the room, and a practical toolkit meant to turn those takeaways into action. We hope they prove valuable both to those of you who joined us at GIC Insights and those of you who are looking for new, innovative ways to keep your business resilient, productive, and focused on the long term.

Sincerely,

Chow Kiat Lim
Chief Executive Officer, GIC
& Strategic Advisor, FCLTGlobal

Sarah Williamson
Chief Executive Officer, FCLTGlobal

DISCUSSION

Companies were rewarded in the past for perceived efficiencies and lean balance sheets, tight supply chains, just-in-time delivery, and returning capital to shareholders to the fullest extent possible.

Now, firms are facing disruptions on many fronts including inflation affecting the affordability of their products and services, increasing geopolitical fragmentation threatening the security of supply chains and markets, and sustainability imperatives, among other important trends. As a result, companies are trying to build resilience, or the ability to withstand or adapt to disruption, into their operations and their balance sheets.

The energy market provides a timely example. Whereas recent years have seen a focus on shifting to cleaner energy sources, the geopolitical turbulence of the past year has forced companies to balance their energy transition with ensuring the security of their energy supply and managing volatile energy prices. Building resilience in response to any one of these three pressures is difficult – addressing all three simultaneously is a challenge that many companies are still working to meet. And yet, there is a perception that financial markets don't value resilience and that many investors see it as bloat. The reality is that investors do value resilience, but incorporate it at the portfolio level through diversification, instead of on a company-by-company basis which comes with higher costs; leading asset owners are already headed in this direction.[1] This results in both investors and companies placing a high priority on resilience and agility, but approaching it in very different ways that are seldom mutually beneficial.

How, then, can companies best build long-term resilience into their business while staying lean? How can investors evaluate and appropriately value that resilience? And how can they both work together to maintain a focus on long-term performance?

Sarah Williamson introduced the session with the concept of a new "resilient frontier", prompting investor participants to consider a new three-dimensional method of portfolio construction that integrates risk, return and resilience together to deliver desired outcomes.

The discussion was started by Theresa Whitmarsh, former Executive Director of the Washington State Investment Board and board chair of FCLTGlobal. Whitmarsh began by exploring the challenging operating environment in 2022 and questioned how companies and investors can adapt. Recent events have shown that building greater resilience is imperative for companies in particular. However, citing data from FCLTCompass, Whitmarsh noted that the increased focus placed by capital markets on long-termism during the pandemic was not a lasting trend, and both companies' and investors' investment horizons have shortened over the past year.

For companies, defining operational inputs and outcomes on key risk areas will demonstrate foresight that investors value. And for investors, the critical question is also one of value, said Whitmarsh. What are investors willing to pay for resilience? To make considering resilience on a firm level worthwhile, investors must determine whether resilience is a leading indicator of returns or a drag on near-term performance.

After the introduction, participants considered the topic at hand and several key themes emerged from the conversation.

The tension between resilience and efficiency is real

Participants observed this tension – the growing pressure for companies to be resilient to disruptions arising from various transitions while also running efficient businesses – as critical to their ability to weather current storms. Companies are re-evaluating their presence in countries due to geopolitical concerns and are diversifying their supply chains accordingly.

Firms are also working towards becoming more responsive to their many stakeholders, including employees, suppliers, and global customers, particularly in light of a heightened focus on income inequality. Adopting a more inclusive, multi-stakeholder approach will help to address rising costs of living due to persistent inflation, and support the need for a rapid climate transition.

1. Peter Shepard, MSCI; Grace Qiu Tiantian, Ding Li, GIC. "Building Balanced Portfolios for the Long Run." GIC, October 19, 2022. https://www.gic.com.sg/thinkspace/all/building-balanced-portfolios-for-the-long-run-1/

Investors are perceived to place less value on resilience than companies, although many are already accounting for it in their portfolio construction

On the other hand, there is a perception that financial markets are a source of short-term pressures for companies implementing resilience strategies. The financial media is quick to point out profit shortfalls. Sell-side analysts scrutinise quarterly results. Activists wait in the wings for an opportunity. Even investors with a long-term focus might put limited emphasis on resilience, given that their portfolios are so diversified, unlike a particular company focusing on its own operations.

Due to the broad diversification of portfolios – and the importance of benchmark-relative investing that investors tend to emphasise – the performance of a particular company is less relevant to the investor. Therefore, they undervalue resilience relative to the management of the company. But that does not mean that they do not place any value on it, particularly in the face of rising systemic risks, which could be harder to mitigate through diversification because they affect larger proportions of most market index-based portfolios.

Interestingly, private equity firms are valuing resilience more today than in the past given the more challenging return environment, their often more visible results, and their desire to be seen as a responsible owner of companies. There was a broad consensus that private capital is more "patient" than public capital, and that aligning objectives and philosophies is easier to do in the private markets since decisions can be made quickly and without the constraints of near-term profitability.

Long-term investors are starting to identify the factors that demonstrate resilience

Long-term investors are using their fundamental analysis capabilities to identify which corporate resilience strategies are a leading indicator of long-term outperformance instead of a source of short-term underperformance. Specifically, they evaluate companies on how they are demonstrating resilience by understanding their long-term capital allocation plans and the return on that capital. Such analyses could lead to more investment opportunities as companies with greater resilience have the potential to create more value over the long term.

Long-term companies remain committed to their investments in resilience despite short-term pressures and other demands for capital

Companies that have clear strategic roadmaps to build resilience into their operations continue to allocate capital in that area. Examples include moving manufacturing facilities closer to consumers to shorten supply chains and co-locating manufacturing facilities with power generation to improve both efficiency and resilience to energy shocks. These companies are receiving support for resilience-related investments from their boards by running scenario analyses, helping them to develop the capability to deal with various shocks or crises by incorporating contingencies and optionality in balance sheets.

Investors, especially asset owners, are beginning to think about resilience as distinct from traditional measures of risk

Institutional investors must meet expectations that go well beyond hitting a target rate of return with a given level of volatility. Meeting these expectations means being able to adapt to unforeseen events or paradigm shifts and incorporate objectives beyond return. These goals may be related to targets on climate, progress on diversity and inclusion practices, limitations due to geopolitics, and many other issues. When investors ignore these other objectives, disruption often occurs – usually enough to cause the investor to make costly changes at the worst time. Building portfolios that are resilient to changing expectations or guidelines for how return is earned is critical, especially for investors with long-term horizons.

If an investor has made a net-zero commitment, for example, then perhaps their measure of resilience is their carbon emissions or intensity, as they will be unable to hold investments with high carbon outputs over time. If the investor could meet the same risk/return targets with better resilience, why wouldn't they do so? Similarly, an investor may be concerned about being able to hold investments in certain countries over time due to geopolitical implications. If there were similar investments in countries without such risks, it would make sense to adjust their portfolio.

Both companies and investors are expecting momentum on regulation and standard-setting

To better evaluate actions that demonstrate the value of resilience, long-term investors and companies could seek to create common standards that enable them to evaluate resilience better. Standards can be a catalyst for change, but they can be challenging to establish given different investors' varying time horizons and definitions of "good performance". Public market companies will need to adopt new norms, and private markets will likely take cues from the standards set by public markets.

While some thought this momentum could occur from within capital markets, others argued that regulators would need to play a role. There are limits to the free market, one participant said, and the most effective way for markets to incorporate new norms is for governments to better address externalities.

But normalising financial standards takes time and convergence is challenging – the International Financial Reporting Standards (IFRS) and the Generally Accepted Accounting Principles (GAAP) being prime examples. As an example, standardising the assessment of climate-related risks and opportunities is proving to be difficult – quantifying other areas of resilience could be even more so. From a practical standpoint, investors in the room coalesced around several metrics as a proxy for resilience. An example cited was margins – one participant put it plainly: "Historically high margins mean a company is not investing in resilience enough, while low margins could imply the company is overdoing it." Importantly, such metrics will only offer a robust indicator of resilience if they are tailored to companies' long-term strategies and those of their competitors.

Participants' insights were used to develop a set of tools that can help investors and companies build resilience into their own organisations. These ideas can be found on the pages that follow.

BUILDING RESILIENCE

A Toolkit for Defining and Adapting to Global Shifts

Businesses today are confronted with a wide array of challenges, from a volatile macroeconomic environment to rising geopolitical tensions, as well as the pressure to manage constant technological disruption and the low-carbon transition. Incorporating mechanisms to navigate these disruptions will be critical to sustaining long-term enterprise value and performance. Likewise, investors must now ask themselves, “What are we willing to pay for resilience?” and put processes in place to make those determinations.

For companies, defining these issues, and taking clear steps to address them, demonstrates foresight that investors value. For investors, clarifying which elements of resilience they consider critical to long-term performance will give investee companies clear goals to achieve.

COMPANIES

- Use scenario planning and stress testing to identify the shocks that will result in permanent or lasting failure.
- Issue a “resilience statement” that details the costs involved in building up resilience in terms of long-term business strategy, and defines how investors can hold firms accountable to it.
- Establish a “junior board” to reflect a younger perspective in strategic decisions. Demographics shape time horizons, and younger boards would help prioritise resilience.
- Introduce deferred compensation or lock-ups into executive pay packages to focus action on longer-term goals.
- Have cash on hand to weather uncertainty, especially in the current high-rate environment.
- Consider the impact of multi-share class structures on resilience.

INVESTORS

- Create sector-specific “value anchors”, or key performance indicators, that companies can aim for. It must be clearly defined so that lack of action would be a sign of potential underperformance.
- Incorporate a view on resilience into official risk appetite statements and offer it as an example to portfolio companies.
- Place value on optionality of company balance sheets rather than emphasising return of capital.
- Define a strategy to manage climate-related investment risks.
- Assess “obsolescence risk” in due diligence and in security selection.

This is by no means an exhaustive list of tools and instead aims to offer firms and investors a tangible starting point to incorporate resilience as part of their long-term strategies. Should you wish for us to expand our research on this topic, please reach out to research@fcltglobal.org.

ACKNOWLEDGMENTS

Project Contributors

Shang Thong Chie

Trang Chu Minh

Mah Lay Choon

Matthew Leatherman

Demi McClure

Ross Parker

Joel Paula

About GIC

GIC is a leading global investment firm established in 1981 to secure Singapore’s financial future. As the manager of Singapore’s foreign reserves, we take a long-term, disciplined approach to investing, and are uniquely positioned across a wide range of asset classes and active strategies globally. These include equities, fixed income, real estate, private equity, venture capital, and infrastructure.
Our long-term approach, multi-asset capabilities, and global connectivity enable us to be an investor of choice. We seek to add meaningful value to our investments. Headquartered in Singapore, we have a global talent force of over 1,900 people in 11 key financial cities and have investments in over 40 countries.

About FCLTGlobal

FCLTGlobal’s mission is to focus capital on the long term to support a sustainable and prosperous economy. We are a non-profit organization whose members are leading companies and investors worldwide that develops actionable research and tools to drive long-term value creation for savers and communities. To learn more, visit FCLTGlobal.org.

31 Saint James Avenue, Suite 890, Boston, MA 02116 USA | +1 617 203 6599 | www.FCLTGlobal.org