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10 years after the subprime crisis global finance sector still ignores long-term risks

Markets unprepared for impact of energy transition and artificial intelligence

LONDON/NEW YORK – Ten years after the start of the subprime mortgage crisis analysts and investors still largely ignore long-term financial risks, warns a report launched today by the think tank 2° Investing Initiative and The Generation Foundation.

It finds that equity research analysts and credit rating agencies focus three to five years ahead and overlook risks to the long-term viability of companies, even though the value of institutional investors' portfolios is mostly based on cash flows beyond five years. Lack of demand from the investment community for long-term research is partly to blame.

Mona Naqvi, Program Manager for the 2° Investing Initiative and co-author of the report, said: *"The financial sector fails to properly assess the impact of the low-carbon energy transition, artificial intelligence and other long-term trends. If assets are not priced accurately investors may suffer unexpected losses and stock market bubbles may form, imposing tremendous costs on society when they burst. Short-term analysis may also miss business opportunities and lead to underinvestment in sectors that can benefit society."*

Ten years ago, in February 2007, the US Federal Home Loan Mortgage Corporation (Freddie Mac) announced that it would no longer buy subprime mortgages and related securities, triggering a global financial crisis, with nearly 9 million jobs lost in the US alone. The report says it was not an unpredictable "black swan" event but a "white swan in the dark" which could have been spotted if analysts had looked further ahead and not relied on the assumption that homes would always sell for more than their purchase price.

Stan Dupré, founder and CEO of the 2° Investing Initiative, said: *"Financial policymakers responded to the crisis by increasing capital charges to strengthen the 'financial cushion' of financial institutions, but the core problem remained unaddressed: financial analysts and investors still do not assess long-term risks that are non-cyclical and non-linear, like the oversupply of homes they suddenly discovered in February 2007."*

*"**All Swans Are Black in the Dark**: How the short-term focus of financial analysis does not shed light on long-term risks"* is the first comprehensive study of the time horizons used by equity research analysts and credit ratings agencies, the link between company value and earnings over time, and long-term risk. It finds:

- The value of stock and bonds portfolios is usually based on companies' 'expected' long-term cash flows (to pay dividends, repay debt and fuel stock price growth) which are exposed to long-term risks.
- A majority of asset owners have long-term liabilities and invest to optimize returns over 10 to 50 years. Households and pension funds alone own 48% of the US domestic equity market.
- In most sectors of the S&P500 more than 70% of the net present value of a company is based on cash flows beyond five years. For most S&P500 corporate bonds, the value derives from cash flows of 10 years or more.
- However, equity analysts almost exclusively focus risk analysis on the next one to five years and extrapolate future cash flow trends: 74% of forecasts fall within three years and 94% within five years

according to analysis of entries on the Bloomberg terminal. Credit ratings agencies largely focus on the next three to five years and risks beyond that period rarely influence ratings action.

The report shows that analysts almost systematically ignore financial risks that are: long-term – likely to materialize after five years; non-linear – developing faster than early signals suggest; and non-cyclical – with no precedent in recent history. Stan Dupré said: *"The type of risk that triggered the sub-prime mortgage crash and the global financial crisis is likely to be missed again."*

The report calls these foreseeable risks "white swans in the dark", and it identifies a broad range of sectors where companies are valued on the assumption that business as usual trends will continue:

- **The energy transition to a low-carbon economy** may fundamentally alter carbon-intensive sectors and impact financial markets. Financial models may not capture unconventional risks from national decarbonization policies, falling costs of low-carbon technologies such as energy storage and renewables, and the threat of lawsuits and reputational damage to high emitters.
- **Artificial intelligence and automation** have the potential to disrupt numerous sectors. For example, Barclays Research estimates that self-driving cars coupled with increased car sharing, could cause a 40% fall in car sales by 2040. Experts suggest there could be 10 million self-driving cars on the roads by 2020.
- **Nuclear power** operators rely on governments to cap insurance costs. It cost $50 billion to clean up after the Fukushima disaster and if operators had to buy accident insurance, premiums could rise by a factor of 1,000. If governments withdrew financial support for the sector in the face of public opposition it could wipe out the nuclear industry. US legislation comes up for review in 2025.
- **An offshore oil rig accident** is low risk at any given time, but extremely likely across the whole industry in the long run. The 2015 Deepwater Horizon disaster cost BP more than $61 billion. A repeat would have a major impact on an oil major's profits and could lead to calls for a ban on deep water drilling.

The report notes that financial regulators are starting to act over the lack of analysis of climate risk, suggesting they recognize the dangers of mispricing. The Financial Stability Board has set up the *Task Force on Climate-related Financial Disclosure* (TCFD) which is due to make its final recommendations soon.

Daniela Saltzman, Director, Generation Investment Management, said: *"This report demonstrates why financial models and tools must be refined. The 2° Investing Initiative and The Generation Foundation's analysis reveals how both equity and credit analysts rely on short-term models and practices, implying that certain types of risk are missed, preventing capital from achieving socially and environmentally optimal outcomes. The implications of this report must be taken seriously by the investment community.*"

A sister report, developed by 2° Investing Initiative and The Generation Foundation, and authored by Mercer Investment Consulting LLC, analyzed the turnover of over 3,500 'long-only' institutional equity portfolios from 2004 to 2016. ***The Long and Winding Road****: How long-only equity managers turn over their portfolios every 1.7 years,* finds:

- Although a majority of asset owners such as pension funds and insurers have long-term liabilities of 20 years or more, institutional equity funds manage their portfolios with short-term time horizons, turning them over every 21 months on average.
- Nearly 90% of institutional equity funds turn over their portfolios in less than three years, even though research suggests that a longer holding period benefits financial performance.

Stan Dupré said: *"Analysts' focus on short-term risks is not surprising since there is basically no demand for long-term research from investors. This is a failing which the whole financial community should address."*

Daniela Saltzman said: *"Financial markets must adequately assess and incorporate the impact of long-term trends, like the transition to a low-carbon economy, in asset prices. Long term investment horizons are crucial to ensure capital is efficiently allocated to businesses aligned with a low-carbon, healthy, inclusive and safe society."*

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NOTES TO EDITORS

2° Investing Initiative, Generation Foundation have launched the Tragedy of the Horizon programme to explore the finance sector's short term risk assessment frameworks, examine the consequences of its limited ability to capture long-term risks and develop solutions. These are the first two reports:

All Swans Are Black in the Dark*: How the short-term focus of financial analysis does not shed light on long-term risks".* 2° Investing Initiative, Generation Foundation. Feb 2017. The report is the first comprehensive study of the time horizons used by equity research analysts and credit ratings agencies, it presents new research into the link between company value and expected earnings over time based on analysis of the S&P 500 index, and it coins the term "white swan in the dark" to describe long-term, non-linear, non-cyclical risk that is largely ignored by investors and analysts. It is based on an analysis of market data, third party research and workshops and interviews with leading financial institutions.

The Long and Winding Road*: How long-only equity managers turn over their portfolios every 1.7 years.* Mercer, 2° Investing Initiative, Generation Foundation. Feb 2017.

This topic will be on the agenda of the new *High Level Expert Group on Sustainable Finance* that the European Commission (DG FISMA) launched in January 2017 to develop a policy-roadmap to address obstacles to long term and sustainable finance.

2° Investing initiative is an independent think tank with offices in New York, Washington DC, London, Paris and Berlin. It conducts independent research and works with investors and governments to develop the metrics, tools and policies to align financial markets with long-term investment goals and international climate targets. It notably supported the French Government in drafting the world's first law on mandatory climate disclosure for investors, designed to ensure financial markets support the Paris Agreement to limit climate change to a maximum 2°C. Its CEO and founder, Stan Dupré is a member of the EC High Level Expert Group on Sustainable Finance, and Chairman of the International Organization for Standardization's working group on Climate & Finance (ISO 14097).

The Generation Foundation was established alongside Generation Investment Management LLP ("Generation") in order to strengthen the case for Sustainable Capitalism. The Foundation's strategy in pursuit of this vision is to mobilize asset owners, asset managers, companies and other key participants in financial markets in support of the business case for Sustainable Capitalism. All of the activities of the Foundation, a not-for-profit entity, are funded through a distribution of Generation's annual profitability.

Mercer Investment Consulting LLC is a global consulting leader in talent, health, retirement and investments. Mercer helps clients around the world advance the health, wealth and performance of their most vital asset—their people. Mercer's more than 20,000 employees are based in 43 countries and the firm operates in over 140 countries. Mercer is a wholly owned subsidiary of Marsh & McLennan Companies, a global professional services firm offering clients advice and solutions in the areas of risk, strategy and people.