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“What is Patient Capital and Who Supplies It?”

Abstract:

In comparative political economy (CPE), ‘patient capital’ (‘PC’)– primarily from relational banks – as central to distinguishing national economies. The rise of ‘market-based banking’ highlights the growing inability of commercial banks to be patient. This raises the question of whether alternative forms of PC exist, but CPE lacks a framework to consider PC provision by financial markets. We develop our concept of PC and a framework for determining the investors most likely to provide it - and under which conditions. We define PC as equity or debt whose providers aim to capture benefits specific to long-term investments and who maintain their investment even in the face of adverse short-term conditions for the firm. We argue for determining patience through three questions: 1. Is the investment (loan) intended to be short or long term? 2. Is the investor engaged with management in pursuit of short-term share price performance or creditworthiness? 3. What is the likelihood of exit because of concerns regarding short-term performance? Our framework lays the cornerstones for a new comparative theory of financial systems.

Keywords: corporate finance, financial institutions, financial markets, comparative political economy, varieties of capitalism

JEL classifications: G20; G32; P16;

Word count: 9,658

1. Introduction

The concept of ‘patient capital’ (PC) has long been central to comparative political economy (CPE), as it is viewed as one of the important distinctions between political economies. This literature’s view of non-financial corporation (NFC) finance has been dominated by two simplifying assumptions: 1) that ownership concentration in relational banks and blockholders produces PC, and 2) that financial markets do not.¹ The assumption is that banks and blockholders are patient because their insider position overcomes information asymmetries, enables them to monitor management and thus capture rents or secure strategic advantages (Aoki 2001, 310-14). However, this first assumption is increasingly undermined by numerous trends in finance, notably the decline of relational banking due in part to the increased interdependence between banks and financial markets – as highlighted by the market-based banking (MBB) thesis (Hardie and Howarth 2013; Hardie et al. 2013).² CPE has not seriously examined the evidence for the second assumption because, “less attention has been given to the fact that investors possess different identities, interests, time horizons, and strategies” (Aguilera and Jackson 2010, 523). While CPE has analysed the evolution of alternative capitalist systems under conditions of liberalization (for a review see Deeg and Jackson 2007), it has struggled to develop a new framework for comparing financial systems beyond the old bank-market dichotomy (Deeg 2010).

In contrast, official observers have for decades assumed that PC provision is an important function of capital markets, albeit one they often fail to perform adequately (Kay 2012; Haldane 2012; European Commission 2013; Bank of England 2014). Similarly, a range of other academic literatures does not assume that PC is found primarily in bank-based systems and, instead, highlight an increasingly heterogeneous cast of investors across all financial markets, including those investing for speculative or fundamental reasons (Aspara *et al.* 2014), institutional or individual (Grinstein and Michaely 2005), short- and long-term (Jackson and Petraki 2011; Useem 1996), by propensity for activism (Ryan and Schneider 2002; Goranova and Ryan 2014), market- or politically-driven (Camara 2005), opportunistic or committed (Huo 2014), by incentive to trade on company performance (Lang and

McNicholls 1997), as transient, dedicated or ‘quasi-indexers’, traders or owners (Bushee 1998), and ‘governance-sensitive’ or not (Bushee *et al.* 2014). All these literatures share a view, only recently gaining attention in CPE (e.g., Goyer 2011), that different types of investors exert different pressures on company managers and, within this complex investor world, lie potentially patient investors and lenders.

The recognition of heterogeneity and of the potential for PC from financial institutions other than banks or blockholders underpins our search for a new CPE of financial markets. But if a simple banks *or* markets distinction no longer make sense, what alternative framework is suitable for theory building? MBB suggests we place financial systems along a continuum by the degree of market-based banking. In this paper we extend this continuum approach through a framework for distinguishing investors and lenders on a patient versus impatient dimension. We assume that PC is found in all financial systems and can potentially be provided by a variety of financial organizations. As with MBB, the degree of PC found – both between investor types and at the system level – will be conditioned by institutional differences in financial regulation, tax law, accounting practices, corporate governance rules, social and political norms, etc. We therefore expect systematic variation in the provision of PC, which serves, along with MBB, as a theoretical basis for the comparative analysis of financial systems.

There is surprisingly no common definition of PC, despite broad consensus on what it does: namely, it shields NFCs from the need to react to the short term vicissitudes of financial and product markets, or to focus on short-term financial gains at the expense of long-term gains. Starting from this, we define patient capital as equity or debt whose providers aim to capture benefits (both financial and otherwise) specific to long-term investments and who do not exit their investment or loan if NFC managers do not to respond to short-term market pressures. Such a conception risks a normative assumption that PC is always positive for long-term NFC performance. While we share concerns about excessive short-termism, we do not see PC as inevitably positive, as the managerial autonomy that results from certain types of PC can be used by managers for either beneficial or malign purposes (Davis 2008, 13; Shleifer and Vishny 1997, 742).³

Our approach here distinguishes itself from most existing literature in three ways: first, we focus on the different interests and corporate objectives of debt and equity investors; second, we focus on engagement by investors or lenders with firm management, rather than just time horizons, in defining what is PC and what conditions give rise to it. Neither the dominant shareholder value theory nor the alternative stakeholder theory of investor behaviour provides an adequate understanding of these two elements of PC. Third, we focus closely on varying levels of ‘loyalty’, or the reluctance to exit in spite of disagreement between investor/lender and management (Hirschman 1970, 98).

We develop a framework for analysing both equity investors and debt providers. This follows from the two dominant approaches to corporate governance which recognise that debt providers have distinct interests from investors. Stakeholder theory’s crucial stakeholders certainly include creditors (e.g., Freeman 1984). Likewise, shareholder value theory recognizes that creditors’ interests are potentially antithetical to those of shareholders who prioritise share price and dividends, whereas creditors prioritise creditworthiness (Jensen and Meckling 1976; Camara 2005; Hoskisson *et al.* 2002; Shleifer and Vishny 1997a). Overall, equity investors have an incentive to advocate higher risk investments from which they disproportionately benefit, while creditors bear the greater part of the risk (Jensen and Meckling 1976, 334; Camara 2005, 241; Shleifer and Vishny 1997, 760; Smith and Warner 1979). Such debt-equity conflict plays out across a broad range of corporate decision-making (Grinstein and Michaely 2005; Roe 2006, 34; Jackson and Petraki 2011). Yet neither of these theories fully problematizes this conflict: The shareholder value literature largely subsumes it in the principal-agent problem of ensuring management prioritises shareholder interests (Wright *et al.* 1994, 217), while the stakeholder approach is more concerned with workers’ rather than creditors’ interests.

Separate analysis of debt and equity is increasingly important now because provision of both by a single investor (e.g., relational banks) is far less common in advanced economies (Culpepper 2011). Even institutions investing in both equity and bonds cannot act in a coordinated fashion (Davis 1995, 291; Ryan and Schneider 2002, 562; but also Camara 2005, 342). The general preference of debt providers for stability makes them, *ceteris paribus*, more patient than their equity counterparts, and yet there is wide variation in the patience

of equity investors. Consequently, the varying degrees of patience exhibited by a given firm's investors and creditors create a complex set of pressures on NFC management to pursue short or long-term objectives.

A second innovation is our focus on engagement (or, following Hirschman, the use of voice), rather than just the time horizon of investment, to identify PC. Engagement serves two functions: The first, already broadly recognized, is to overcome information asymmetries through dialogue with management (Aoki 2001; Huo 2014) - this enables an investor/lender to look beyond short-term problems and see whether the firm is positioned to deliver on their long-term objectives (thereby encouraging patience). The second function, which receives far less attention in CPE and which we focus on, is to influence management to align with investor/lender preferences (again, fostering patience if the preferences are long-term). Patient capital therefore requires not just long timeframes of investment or lending, but also support for prioritising long-term over short-term gains.

A focus on engagement further reveals that there is not always a temporal alignment between the holding period of an investment or loan and the timeframe of performance demands by its provider. Private equity, for example, represents 'a corporate governance paradox' (Jackson and Petraki 2011, 35), because it follows a business model based around exit at the highest share price at the earliest opportunity, yet has relatively long holding periods (Gottschalg 2007; Strömberg 2007). Similarly, venture capital is 'a hybrid between a Hausbank and stock-market investors' (Crouch 2005, 132). Index-following investors make long-term investments and so have a seemingly high incentive to engage (Gillan and Starks 2000; Monks and Minow 1995), but most index fund managers do not engage NFC managers (Useem 1996; 179); Activist hedge funds focus on short-term share price performance by forcing mergers, selling assets or increasing dividends (Bratton 2006), but may remain invested for extended periods (*ibid.*; Jackson and Petraki 2011). This temporal complexity also supports our emphasis on patience as a continuum. We therefore ask under what circumstances do investors engage and with what purpose?

We supplement existing literature by interviews with 51 financial market professionals, conducted 2012-2015 in the UK, US, Canada, Belgium and Greece. However, space constraints necessitate a narrow focus on the *potential influence of capital* and a neglect of

other stakeholders (for broader approaches, Aguilera and Jackson 2010; Roe 2006; Gourevitch and Shinn 2005; Goyer 2011). We also subsume or ignore other differences between investors such as blockholders versus minority shareholders (e.g., Gourevitch and Shinn 2005). In the next section we develop our three-question framework for determining the relative patience of investors and lenders. In the subsequent section we tentatively place some key investor types along the continuum of patience.

2. Who Provides Patient Capital?

Our framework for determining the patience of any given investor or lender is constructed on three sequential questions, in each case asking the extent to which short-term share price performance or creditworthiness influences their decisions. These sequential questions focus on initial investment, engagement and loyalty: 1. Is the investment (loan) intended to be for a short or long period of time? An investment planned to be short-term is by definition motivated by short-term performance, and represents low patience, regardless of any engagement. A long-term intention is a necessary but not sufficient condition for patience, and we therefore ask the next question: 2. Is the investor engaged with management in pursuit of short-term share price performance or creditworthiness? In our framework, investors that have a long-term intended investment timeframe, but engage in pursuit of short-term performance, have lower levels of patience. Absence of engagement for short-term performance is therefore a necessary condition for a higher level of patience on our continuum. Determining the highest level of patience takes us to our third question: 3. What is the likelihood of the long-term investor / lender that does not engage in pursuit of short-term performance then exiting because of concerns regarding short-term performance? An investor that exits at this stage, i.e., demonstrates low loyalty (Hirschman 1970), has lower levels of patience; an investor that does not exit has high patience. Figure 1 below visualizes our approach.

[Figure 1 about here]

In the remainder of this section we focus in greater detail on these three questions and the influences on investor decisions at each stage. To be clear, what follows is not a decision tree in which prior decisions determine a path from which the investor cannot deviate or to which it cannot return: An investor unengaged at one point in time can become engaged later (just as a short-term investor might choose to become a long-term investor or a long-term investor might exit in the short run). Rather, we see this as an heuristic for analysing investors and lenders.

Question 1: Is the initial investment intended to be short or long-term?

The first necessary condition for PC is *long-term* in, or lending to, NFCs. An investor or lender planning a short-term investment is unlikely to change that to long-term, and we therefore seek to exclude those investors with no possibility of patience. There is potential for ‘patience by default’ (Harrison, this volume), when an investment that is intended to be short-term becomes unexpectedly difficult to exit, but investors will also vary as to how great an effort they will make to exit, and how willing they will be to make investments where difficulties of exit may occur. There is no clear consensus in the literature regarding what is long-term. Is the initial maturity of investment, or the actual holding period of that investment, the determinant? Does long-term mean a minimum number of years? There are reasons to question whether we should see any investment timeframe in fixed temporal terms (Jackson and Petraki 2011). We will argue that a necessary condition for PC is that the investment or loan is intended to be long term, and we judge an investment at this first stage based on ex ante plan rather than ex post behaviour. But this still begs the questions of what we consider long term and how methodologically we determine what is intended.

We argue that neither the type of financial instrument – equity, bond or loan – nor its initial maturity determines alone whether an investment or loan is intended to be long term. When in the form of equity investment, the maturity is effectively unlimited and long-term is typically understood to mean that the investor intends to hold the investment for a multi-year or an indefinite time period. When in the form of lending, PC is typically equated with long-term (multi-year) loans on the assumption that they cannot (or will not) be traded or securitized. Within the CPE literature, corporate bonds, however, are not typically seen as a potential source of PC. This is problematic because, as the MBB approach emphasizes, the clear distinction between loans and bonds has become increasingly artificial due to the regular marketization of loans (e.g., via securitization), which turns them into bond-like instruments and gives banks and purchasers of these securities the option of exit from lending before the contractual maturity is reached (Hardie et al. 2013; Hardie and Howarth 2013). Moreover, from the perspective of a NFC, long-term bonds held to maturity differ little from a long-term bank loan kept on the bank's books. A longer-maturity bond or securitized long-term loan resold in the market will, however, potentially increase future borrowing costs. **Intended holding period** of investment (including in some instances an intended reinvestment at the formal maturity) must therefore be the means of determining whether an investment or loan is short or long-term.

How we can know ex ante what holding period an investor or lender plans? Sometimes an investor or lender's intended holding period is clear from the stated business model: for example, money market mutual funds have limitations on the maximum maturity of the investments they make, and we can say with confidence that high frequency traders do not plan on holding investments even overnight. However, this is frequently not the case. We therefore use a proxy measures to assess the intended holding period, based on past behaviour - investors as individuals or organizations (and especially broad types of investors) exhibit observable patterns of behaviour regarding holding periods, investment turnover, investment strategies. and performance measurement From these measures, we can reasonably infer what investors intend in most instances and classify investor types accordingly (Bushee 1998, 307).

There are a number of influences on investors' and lenders' initial planned investment timeframes – some springing from institutional incentives or constraints (e.g.,

regulatory mandates) and others from strategic choices. For example, pension funds and life insurance companies investing directly (rather than using external managers) seek to meet their predominantly long-term liabilities, predisposing them to a longer holding period where they are paid a premium for their low liquidity needs. Holding periods are also guided by investor beliefs about which investment strategy delivers superior returns: some favour short-term trading strategies, others longer-term fundamental analysis and investment (see Baillie Gifford, this volume). In addition to fiduciary obligations, investor mandates, and investor beliefs about superior investment strategies, the intended length of investment can also be shaped by the tax treatment of long versus short-term gains. Relationship banking is in this regard also a special case where a long-term intention results from an ability to profit from multiple transactions from which NFCs cannot easily defect (Aoki 2001, 310-314).

Question 2: Are Investors with Long-Term Initial Intended Investment Engaged in Pursuit of Short-Term Share Price Performance or Creditworthiness?

An investor deemed short term in question 1 is impatient. Once an investor is deemed to be long-term in their initial intended investment, however, the next question is whether that investor will utilise voice (Hirschman 1970) to influence NFC management into following policies focused on the short term. A key argument of this article is that investors engaged in pursuit of short-term performance (investors in the 'yes' box of figure 1) are relatively impatient, regardless of their intended or actual holding period. Investors can choose not to engage, or engage with a variety of aims (Goronova and Ryan 2014). This second question therefore distinguishes these short-term engaged investors from those who are either unengaged, who are engaged for long-term objectives, or who are engaged in the interests of other stakeholders, such as in the case of Socially Responsible Investment (these investors are in the 'no' box of Figure 1). Although figure 1 allows us to discern the full range of patient capital, we focus the questions around the issue of short-termism because overcoming this is a necessary condition for greater patience. Engagement is the process whereby investors attempt, through various forms of dialogue, to align management with their objectives. This might facilitate patience by improving an investor's information, but engagement is not in itself an indication of patience. In this section we examine first the

dynamics around the decision by investors/lenders to engage or not. We then examine reasons for engagement for the short-term followed by engagement for other objectives.

The Decision to Engage

The forms of engagement available to different investors and lenders will shape their decision to engage, as well as the intensity and efficacy of their engagement. Equity investors have voting rights and perhaps board seats attached to their shareholdings. However, voting will usually in itself only be sufficient for blockholders, and voting against management is relatively rare (*Financial Times*, 1 November 2015; Choi and Finch 2008). For large, non-blockholder equity investors, two-way private interaction with management is likely to be common (Useem 1996), as are, to varying degrees, press briefings, off the record comments and shareholder coalition building. Debt covenants (Smith and Warner 1979) negotiated between NFC and investors are also a form of engagement. Activist investors use particularly public engagement methods.

At its root, the decision to engage is a cost-benefit calculation based largely on investor characteristics (Ryan and Schneider 2002): The investor must answer a two-part question: is engagement likely to make a positive difference, and would we benefit on balance? The distinction between a fund itself and its fund management company is important in understanding the complexity of the engagement decision, and best illustrated by the example of 'passive' index-following funds. The investor in a passive equity fund may benefit from successful engagement, as the specific share price rises. The fund management company, however, competes for inflows through low costs and close tracking of the relevant index; for them the incentives to engage are low. With careful analysis we can divide investors into those for whom we expect the cost of engagement to exceed the benefit and those for whom we do not. It is also clear that investors overwhelmingly choose to engage when there is poor performance in equity prices or creditworthiness (Useem 1996; Hebb 2008), with varied views on what constitutes poor performance.

Broader institutional settings also influence engagement, and these vary considerably cross-nationally. The rules governing minority shareholder protection (MSP), for example, shape the degree to which diffused shareholders' voices will be heard (Roe 2006, 96). Shareholder coalition-building regulations and takeover protection, either as a

result of formal regulation or NFC-specific government intervention, both influence engagement (Roe 2006, 34; 45). Worker representation on German boards is frequently noted as a limit on successful investor engagement (e.g. Roe 2006; Goyer 2011). Blockholders may oppose initiatives by diffuse shareholders, or encourage free riding on their monitoring (Porter 1992, 42-6; Gourevitch and Shinn 2005, 112). Where NFC defection is difficult, investors and lenders have greater 'financial power' and engagement is likely to be more beneficial to them (Zysman 1983). In reaction to that possibility, many NFCs actively seek the 'right' investors (Useem 1996) and alternative financing sources to discourage engagement by limiting likely success.

Engagement in Pursuit of Short-Term Performance

The most common aim of investors or lenders is an improved share price (equity) or creditworthiness (debt). As noted earlier, an investor with a long intended investment who uses engagement in pursuit of short-term performance is relatively impatient. This is a surprisingly common situation, and many NFC managers lament that institutional investors' 'clocks click faster than their own' regardless of holding period (Useem 1996, 84; also Jackson and Petraki 2011, 10)⁴. As one CFO observed, 'While many of them are long-term holders, they're also looking for short-term fixes. When the stock is selling below book, they'll always have an idea. 'Why don't you sell this and use the proceeds to buy back stock?'' (Useem 1996, 84).

This temporal inconsistency results from two broad institutional constraints: The first is legal and regulatory requirements, including the nature of an investor's fiduciary duty to those investing in the fund (Black 1990; Camara 2005; Davis 2008). We focus here, however, on the second constraint, namely performance measurement systems that push many fund managers toward impatience. For nearly all fund managers, success means maximizing the volume of funds under management, and the time horizon of performance measurement reflects this. Fund manager interviewees consistently repeat NFC managers' complaint: their own investors' clocks tick faster than they should. Even pension funds often evaluate their external fund managers quarterly. Mutual funds, it is often argued, have investors able to exit at will, and who do so in the event of relative underperformance. However, individual investors in mutual funds typically remain invested, and it is further

investment into mutual funds that is highly sensitive to short term performance (Camara 2005, 228). The result in terms of seeking short-term NFC performance is the same. Both these regulatory and performance requirements could equally prompt exit or engagement aimed at short-term performance. For another group of investors, such as activist hedge funds, the decisions to invest and engage for short-term performance are made simultaneously as part of their investment strategy.

Engagement in Pursuit of Outcomes Other Than Short-Term Performance

Investors engaging in favour of long-term performance (amongst those in the 'no' box in Figure 1) are mainly driven by three motivations. First, some fund management companies invest long-term and engage in pursuit of long-term performance, because they believe this strategy results in outperformance. For them, their success and relative importance in financial markets depend on being able to convince their own investors to be patient. This only partly depends on achieving long-term outperformance. However, such investors are relatively rare (see Baillie Gifford, this volume). The second and more important influence favouring engagement for long-term performance is the nature of liabilities, particularly the largely-known liabilities of pension funds and life insurance companies. The relative certainty of further inflows also mitigates against having to demonstrate short-term performance, similarly increasing incentives to engage for long-term performance.

Finally, investors with other motivations than performance may also engage for long-term performance. An example is foundations, motivated often by a desire for family members being senior managers across generations, or by the 'psychological benefits of control' (Gourevitch and Shinn 2005, 110). These other motivations may be dominant, but long-term performance may also be important.

Other motivations for long-term engagement include seeking benefits for other stakeholders. Socially Responsible Investors, trade union controlled pension funds and family owners are all potentially such investors. Family owners may be paternalistic towards the workforce or have 'a social conscience' (Roe 2006, 96), although both may also be positive for firm performance (Lumpkin and Brigham 2011). Government-related investors and lenders goals have policy-related goals. All such investors are likely to engage with goals

other than, or in conjunction with, performance, and the performance sought is more likely to be long-term.

Question 3: How Likely are Investors or Lenders to Exit in Reaction to Poor Short-Term Performance?

Our third and final question is how likely are investors to exit if management does not prioritise short-term performance. Answers to this question allow further differentiation on a continuum of patience (see figure 2 below). Clearly, an investor engaged in pursuit of long-term objectives is less likely to exit, i.e., remain loyal, in reaction to short-term performance. Though it could occur following management decisions (under-investing or increasing borrowing to finance dividend payments, for example) that threaten long-term performance. Notably, some investors may be forced to exit despite prioritising long-term performance: this may occur due to accounting rules or performance measurement (including 'marking to market'). Others may be forced to exit to pay for withdrawals by their own investors or lenders.

Issues surrounding loyalty are also influential on any exit decision. Some may not exit because they are *unconsciously* loyal as a result of 'the general difficulties of recognizing change' (Hirschman 1970, 91): This generally describes ill-informed investors, particularly individuals. *Conscious* loyalty is more significant for determining relative patience and refers to 'the reluctance to exit in spite of disagreement with the organization...[and] understood in terms of a generalized concept of penalty for exit' (*ibid.*, 98). At an extremely low level of loyalty, for example, a long-term investor could actually have a similar level of patience to investors engaged in pursuit of short-term performance. For example, a small fund manager, driven by the same performance measurement constraints discussed above, may free ride on other investors' engagement but immediately exit if that engagement is unsuccessful. In other words, some significant degree of loyalty is necessary for an investor/lender to rise above the low-level patience categorization. What then distinguishes low from very high levels of patience is the relative degree of loyalty (per Figure 1).

What may lead to greater loyalty? Penalties for exit that may induce loyalty come from a number of sources. They are rarely imposed by the NFC receiving the investment, though some loan agreements restrict transfers to another lender. Regulation and accounting rules may also likely significantly raise the cost of exit. For example, accounting rules related to the investment accounts of banks (Hardie 2012), or to the matching of liabilities with known future obligations by pension and insurance companies (e.g., Bank of England 2014, 27), may act as significant disincentives to exit. Investors seeking to outperform a particular index face internal restrictions on 'off index' investment that limit exit (Hardie 2012). Investor size may also increase exit costs when markets are insufficiently liquid – a problem confronted by Warren Buffet. Investors may also remain loyal because the attractiveness of alternative investments is limited. For example, an investor needing to buy long-dated creditworthy bonds may have few alternatives to holding government bonds. Costs of exit could also include losing the private benefits of control that is particularly important to some investors, notably families.

3. Relative Patience of Investor Types

In this section we discuss a number of investor types and their potential – and propensity – for PC provision. In Figure 2 we provide a provisional placement of these investors along a continuum of patience. In most case we suggest what we see as the likely range in which any given investor type is likely to operate.

[Figure 2 about here]

Private Equity (PE)

PE has long been a subject of debate, initially between those who see it as overcoming of agency costs for long-term advantage (Jensen 1989) and those who view it as 'transitory' (Rappaport 1990), and more recently around its impact on NFC performance, investment

and labour (e.g., Wright *et al.* 2007; Davis *et al.* 2011; Applebaum and Batt 2012; Bruining, Verwaal and Wright 2013). This debate highlights the significant heterogeneity of private equity and of the kinds of investments they make (Bacon *et al.* 2013; Hoskisson *et al.* 2013; Gospel, Pendleton and Vitols 2014). This heterogeneity precludes a single conclusion regarding PE patience. We can, however, make some general observations that have an influence on their placement on our continuum. First, private equity's initial intended investment, based on analysis of their historical holding periods, is long-term – generally 4-5 years (e.g. Strömberg 2008; Wright *et al.* 2007, 59; Gospel and Pendleton 2014, 5). Second, private equity investors are generally amongst the most highly and effectively engaged in influencing NFC management.⁵ Third, the nature of PE investment makes exit difficult, meaning loyalty is likely to be high. Determining PE patience largely depends therefore on whether or not that engagement is directed at short-term performance.

Exit is fundamental to PE's realization of returns, so they 'are under significant pressure to achieve their target returns and hence work towards a timely exit' (Wright *et al.* 2007, 58). This pressure is in turn passed on to the NFCs in which they invest, and it often includes pressures for short-term performance or returns. For example, the (increasing) use of 'recapitalizations' – taking on more debt to pay dividends to equity holders – and other financial engineering early in the period of private equity ownership demonstrates impatience without exit (Wright *et al.* 2007; Appelbaum, Batt and Lee 2014,63; Gospel and Pendleton 2014, 27). This under-researched activity is significant: in the UK in 2005, for example, recapitalizations were more than half the volumes of full exits (Wright *et al.* 2007, 60).

Taken overall, engagement by PE suggests lower levels of patience, though there is considerable variation as a result of different strategies for achieving returns. Strategies focused on growth or entrepreneurship suggest greater patience, those focused on efficiency or administrative improvement are likely to be less patient (Bruining, Verwaal and Wright 2013; Hoskisson *et al.* 2013). It may be that over time the predominant strategy has moved towards seeking longer-term growth (Wright 2013). However, there is also evidence that larger firms are more likely to focus on efficiency (Hoskisson *et al.* 2013), the high leverage more closely associated with financial engineering (*ibid.*; Wright *et al.* 1994, 216)

and early exit (Wright, Thompson and Robbie 1992). In conclusion, PE covers a broad range in figure 2's continuum of investor patience, representing low to medium levels of PC.

Venture Capital (VC)

VC is another form of PE, but is considered separately here (see also Klingler-Vidra, this volume), and we treat angel investors (Harrison, this volume) as a sub-set of VC. VC shares the basic characteristics of PE in having a long-term initial intended investment (generally even longer than PE [Ernst and Young 2014]), being very engaged and planning on exit to realise returns. VC is focused on growth rather than efficiency and financial engineering – the opportunities for which are likely to be very limited – suggesting an overlap with the more patient providers of PE, with the likelihood of a slower realization of that growth suggesting potentially greater patience. This is reinforced by the low likelihood of realizing value prior to exit (Deutsche Bundesbank 2000, 17). That said, VC-invested firms are not without shorter-term pressures, as subsequent rounds of VC financing normally depend on meeting interim performance benchmarks (Guler 2007; Lerner *et al.* 2011, 13). A further factor indicating patience in the case of angels is a focus on other priorities than short-term performance (Freear *et al.* 1995; van Osnabrugge 2000). The evidence suggests VC should be seen as generally medium levels of PC.

Pension Funds and Insurance

We place both pension funds and insurance, when they are investing directly rather than via fund management companies, in the patient half of our continuum, albeit with a broad range that reflects the equally broad range of their investment activities. Pension funds and (life) insurance share a need to invest to meet specific liabilities, and the long-term nature of most of these liabilities results in higher levels of patience (Davis 1995; Clark 2000). In addition, inflows into the funds from employees and the buyers of insurance are far more certain, and unplanned withdrawals far less likely. This reduces the short-term performance pressure on pension fund managers; interviewees suggest a 3-5 year average performance measurement for them is not uncommon (also Hebb 2008, 94). At the most patient end are 'Liability Driven Investment' strategies based on buying and holding (often very long maturity) bonds, to meet specific liabilities. This leads to significant disincentives to exit because of a lack of alternatives (Bank of England 2014, 27). However, pension fund

investment is predicated also on the growing value of investments and not just generating income: For public pension funds, this often means that politicians impose highly ambitious return targets which, in turn, reduces patience through more active management and the adoption of short-term investment practices that are hard to marry with pension funds' stated long-term philosophy (Hebb 2008, 6).

Only some of the largest pension funds actively engage, and their large investment positions and visibility give them a high probability of success. Pension fund engagement is increasingly focused on longer-term performance (Hebb 2008, 94), but it also frequently includes opposing such management initiatives as takeover protection (thus pushing toward impatience). US public pension funds have also been accused of being driven by political factors in their engagement (Useem 1996, 102), suggesting an interest in other stakeholders and 'non-pecuniary' returns (Jensen and Meckling 1976). However, in both cases performance targets must be met, so that the interests of other stakeholders are very unlikely to induce the highest levels of patience. Most pension funds do not engage anyway, either because their investment is too small to give enough leverage or because their NFC sponsors do not themselves want to face such engagement (Useem 1996, 57; Davis 2008). Similar conflicts of interest can exist for insurance companies (Brickley, Lease and Smith 1988).

Hedge Funds

Hedge funds follow a very broad range of investment strategies. 'Activist' hedge funds buy small equity stakes in NFCs with the specific purpose of engaging to improve short-term returns (Schneider and Ryan 2011; Gospel *et al.* 2014). They are mostly impatient investors, with intended investment holding periods from under one month to just over one year (IMF (2004, 125). For those few funds that are longer-term investors, any engagement is aimed almost exclusively at short-term performance. For unengaged hedge funds (the majority), some see them as often being more loyal than other investors, because 'lock-up' periods that slow their investors' withdrawals mean they do not have to sell in weak markets (e.g., IMF 2004, 126). On the other hand, their use of borrowing (leverage) to increase investment can make them vulnerable (Davis and Steil 2001, 18; Mackenzie 2003), and the use of stop losses – forced exit in the event of price falls – is common. Many hedge funds

are short-term in their initial intended investment, and those that are more long-term are either engaged for short-term performance or unengaged with low loyalty. Overall, patience is low.

Active Funds

Generalisation across the many thousands of actively managed investment funds must be treated with considerable caution, suggesting a very broad (and tentative) range on our continuum. It is often argued that they face investors able to exit at will - and who do so in the event of short-term relative underperformance - so must be relatively impatient.⁶ The evidence shows that individual investors in funds actually remain invested despite poor performance, but further investment is highly sensitive to short term performance (Camara 2005, 228). Institutional investors into funds claim in interviews that they do not swiftly withdraw funds in the face of poor short-term performance, but active fund manager interviewees certainly feel there is a short-term focus and react accordingly. Even pension funds often evaluate their external fund managers on a quarterly basis. As a result, fund management companies that genuinely prioritise long-term performance are rare (Baillie Gifford, this volume).

Incentives to engage vary with size, concentration and time horizon. However, there are significant disincentives to engagement by fund managers. Board membership, so central to relationship banking, can be problematic where insider trading laws mean they cannot trade the securities of the NFC in question (Black 1990, 147-8). Fund management companies are also wary of engagement that risks their relationship with the NFCs whose pension funds they manage or seek to manage (Useem 1996, 60; Davis 2008; on managerial compensation, David, Kochhar and Levitas 1998). Responsible Investors (SRI) are the notable exception in this category, as they will often engage for the interests of other stakeholders, including the environment.

Smaller fund investors can exit more easily than either index-followers or very large funds (Davis 1995, 170), and so are less loyal. For the many fund managers seeking to outperform a particular index, internal restrictions on 'off index' investment that can limit exit from large investments (Hardie 2012), and the size of investments, can increase exit costs. As with other investors focused on other stakeholders, SRI loyalty may be higher than other

fund managers, but they must also make financial returns to attract funds. Overall, then, active fund managers do not demonstrate high levels of engagement, and, where they do, the aim is more likely to be short-term performance. Exit can be forced in the event of poor performance and loyalty is likely to be low.

Passive Funds

Passive funds must match an index and compete on low fees (Camara 2005, 228). Passive funds are long-term in their initial intended investment, which many see as likely to induce engagement. However, passive funds' low-cost strategy actually discourages engagement beyond voting shares in specific instances, such as takeovers (Useem 1996; also Bushee 1998; Ryan and Schneider 2002, 562). Only the very largest passive fund firms receive the second-order benefit of higher share or bond prices leading to higher investment into financial markets generally and increased funds under management.⁷ They are essentially a 'universal owner', exposed to the performance of the whole economy (Hawley and Williams 2000). Exiting holdings risks deviation from their index. Full exit in reaction to short-term performance is unlikely, suggesting high loyalty. However, small reductions in holdings will occur in the event of under-performance relative to the index, because the equity or bond in question will be a smaller component of the index, and a full exit will occur if the security is dropped from the index followed by the fund. On balance, the likelihood of forced total exit remains low and loyalty is high. Overall, patience is therefore high.

Sovereign Wealth Funds

Sovereign Wealth Funds (SWFs) have become one of the most significant institutional investors in global markets. SWFs are "are government-managed investment vehicles that use national savings to acquire international assets without incurring significant explicit short-term liabilities" (Chwioroth 2014,752). Today SWFs have as many assets under management as private equity and hedge funds combined (Gospel *et al.* 2014, 15). There are three general types of SWFs: the first is a "savings" type fund designed to generate income for future generations (like an endowment); the second kind acts as a holding company for strategic investment by states; and third are "stabilization" funds that even out government income when commodity prices swing (Bernstein *et al.* 2013, 222). Many regard the savings-type SWFs as ideally suited to provide PC because of their mandate

to generate income and returns for a very long timeframe, low pressure to generate short-term profits, and the ability to consider social and political goals (thus potentially acting as SRI). And, indeed, many of them do provide patient equity capital. During and after the Global Financial Crisis, for instance, many large firms and banks actively recruited equity investment by SWFs because they were long-term investors willing to provide much-needed capital during turbulent times (Bolton *et al.* 2012; Gospel *et al.* 2014; Thatcher and Vlandas, this volume). Despite their considerable capacity for patient investment, many SWFs, like pension funds, actually followed mixed investment strategies. The Norwegian SWF, for example, believes in financial market efficiency, so sees the pursuit of adequate risk-adjusted shorter run returns as consistent with long-run wealth preservation (Bolton *et al.* 2012,16). Increasingly, SWFs are investing in private equity or hedge funds, which are generally less patient (Gospel *et al.* 2014, 28). Despite their large size and significant minority ownership in many corporations, SWFs are generally regarded as unengaged investors (Gospel *et al.* 2014, 15). This has most often been attributed to the political sensitivity surrounding investment by funds attached to foreign governments. In sum, SWFs are moderately to highly patient.

Families and Foundations

Despite longstanding predictions of their demise, firms controlled by families (through whole or partial ownership) continue to remain competitive and innovative across a wide range of industries and markets (Andres 2008). In much of Europe, family firms account for 20 to 50% of listed firms, including a number of large MNEs (Colli 2013, 578). When both owned and operated by family members, such firms automatically eliminate inter-temporal agency conflicts between investors and managers. Because family owners also typically seek to pass ownership to subsequent generations, they generally have the longest investment and management horizons of any firm type (Lumpkin and Brigham 2011). While there are circumstance and events that can pressure family investors to focus on short-term results, research has supported the conclusion that family firms managed for long-term returns perform better overall and are financially stronger (Lumpkin and Brigham 2011, 1149). Industrial foundations that are sole or majority owners of firms are often established by founding owners or families who seek to insure that the firm is operated for socially beneficial purposes, including other stakeholders. Foundation ownership is

common in Northern Europe (Thomson 2006, 236). Foundations are non-profit and self-perpetuating entities who own the firm's shares in perpetuity. As such, they constitute the ultimate patient investor.

Banks

Banks span the whole range of patience, from buying short-term commercial paper to equity blockholding and long-term lending (including through the rolling over of short-term loans on maturity) to NFCs. Within this, it is relatively unusual for banks to be providers of both equity and lending, as in the archetypal relationship banking. As noted earlier, patient capital in the form of relational banking involving significant equity ownership by banks in client firms has eroded considerably in the advanced economies; although it has not disappeared, banks are more important as lenders. Many banks continue to make long-term commercial loans which, when retained on their books, represent relatively patient capital. However, they also invest in securities, especially bonds, as part of their trading activities,⁸ and borrow from financial markets to finance this investment and their lending. The extent to which banks engage in this market-based banking determines their patience.

4. Conclusion

We conclude by highlighting what we see as the three main uses for our framework for assessing patient capital: The first is to move CPE further away from dichotomous characterizations of financial systems; the second is to generate and examine hypotheses for NFC managerial decisions in response to investor and lender (im)patience; and, third, to provide a framework for analyzing change in financial systems that recognises how specific investor types and national financial systems are situated along the patient/impatient continuum.

The investor typology we presented leads to considerable empirical challenges, particularly in cross-national comparison. However, in highlighting varying levels of patience amongst lenders and, more importantly, financial market investors, our framework allows more fine-grained cross-national comparisons beyond the usual dichotomy. Our framework assumes, and provides rationale for, the presence of PC even in systems seen as market-

based. The distribution of economies on the continuum is clearly not random. Institutional rules, ranging from tax and accounting regulations to investment mandates, result in systematic differences in the provision of (and possibly demand for) PC. Empirically establishing PC provision in contemporary economies, and thus their place on the continuum, is a critical next step in further research.

Secondly, as equity and debt investors have conflicting views and time horizons on many NFC management decisions, we can also relate our alternative typology of national financial systems to those management decisions, many of which are connected to the labour-related concerns of the varieties of capitalism literature. In so doing, the consideration of the debt versus equity conflict as played out through the patience prism augments existing approaches to analysing the dynamics of corporate governance (for an overview, see Aguilera and Jackson 2010).

Finally, our framework provides another way to make sense of the consequences of financial market developments. Much of this is the changing nature of investors, particularly increased concentration amongst investment managers and the overall growth of institutional savings. Overall, wide trends to decreased holding periods for investments and the rise of a short-term shareholder value focus amongst many investors would support decreased patience over time in advanced economy financial markets, but the picture remains complex and national variation marked. Our approach to PC that is not static and has the potential, in supplementing the market-based banking approach, to offer an alternative typology to analyse modern, developed national financial systems and particularly how market developments impact the provision of PC. We could only hypothesise these impacts in the context of this paper, but believe the framework provides the basis for further research that moves beyond the *cul de sac* of the outdated dichotomy of financial systems.

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¹ Although see Culpepper 2005.

² Market-based banking highlights how banks are dependent on financial markets on both sides of their balance sheets: on the asset side, banks invest in securities; on the liabilities side, banks finance themselves by borrowing on markets rather than using deposits.

³ Useem (1996, 149), however, sees managers as acting in 'the best interests of all'.

⁴ American NFC managers have 5-6 year time horizons, institutional investors one, maybe two, years (Useem 1996, 83).

⁵ An exception is where they are minority shareholders (Bruining, Verwaal and Wright 2013).

⁶ Certainly structures, such as investment trusts in the UK, allow investors in funds to buy and sell their investments, without the fund itself having to buy and sell.

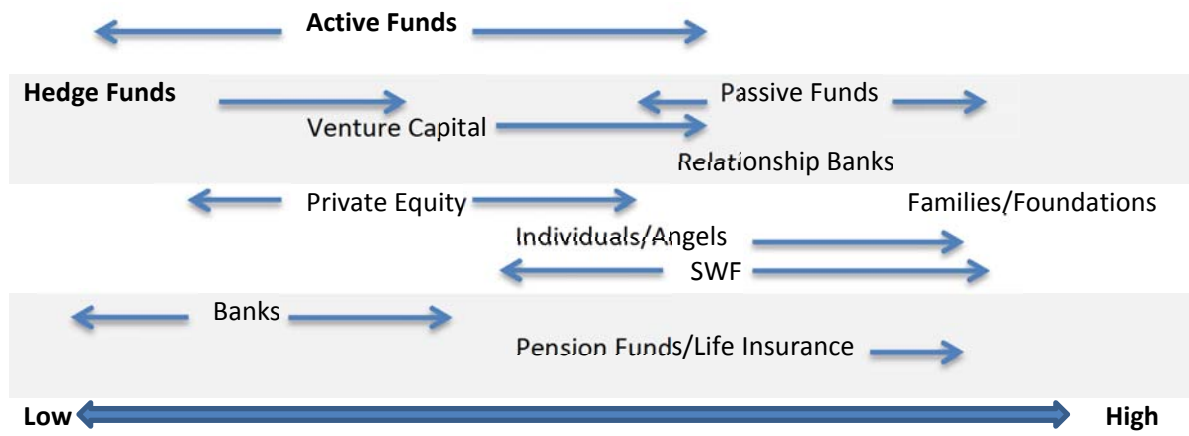
⁷ Active managers' claims regarding the importance of 'stewardship' may also have an impact.

⁸ Regulatory changes such as the implementation of the 'Volcker Rule' in the US are limiting the ability of banks to do this.

Figure 1: Three Steps to Determining Level of Patience

1. Initial Intended Investment Term?	2. Voice Motivated by Short-Term Performance?	3. Likelihood of Exit Motivated by Poor Short-Term Performance?	Patience
Short			Very Low
Long	Yes	High	Low
		High	Low
		Medium	Medium
	No	Unlikely	High
		Almost Never	Very High

Figure 2: A Continuum of Investor Patience¹



¹ We are grateful to Sokol Celo for suggesting this approach.