



# A LONG-TERM MANIFESTO

Iain Campbell, Investment Manager. Third Quarter 2016



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## **IAIN CAMPBELL**

### ***Investment Manager***

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Iain graduated BA in Modern History from Oxford University in 2000. He worked for Goldman Sachs and travelled in Asia, before joining Baillie Gifford in 2004. Most of Iain’s investment career has been focused on Emerging and Developed Asian markets and Iain is member of the Japanese specialist team. Iain is responsible for managing various specialist Developed Asia including Japan portfolios and is also a member of the International Focus Portfolio Construction Group.



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# A LONG-TERM MANIFESTO

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BY IAIN CAMPBELL

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# INTRODUCTION

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*When I speak to clients or prospective clients, I try to spend plenty of time on our long-term philosophy; “the most important bullet point in the presentation,” I tell them. I do this because I think this is where we have an edge; there is a genuine market inefficiency created by short-termism and I think it is an inefficiency that is only exploitable for a limited segment of market participants. Short-termism is driven by the pernicious influence of commission-seeking investment banks, human psychology and the structural problem of badly-designed incentives.*

However, it is not enough to simply identify the inefficiency in order to exploit it. You need an institutional framework that both allows and encourages long-term investing; this framework must emphasise stability, it must limit distractions and it must be true to these principles over the long term so that its employees believe in it. A key part of this is incentivising managers sensibly. Baillie Gifford, with its ownership structure, its antipathy to corporate M&A activity, its scale and DIY approach to information technology and business support, its incentive structure, its internal training and recruitment philosophy and resulting low staff turnover, is one of the small number of institutions that is positioned to put a long-term investment philosophy into practice.

I don't claim to clients that we have cleverer than average investors, or

better systems, or better information or that we work harder or travel further or construct more complex excel sheets. But what we do have is an identifiable market inefficiency, which our unusual structure and philosophy allows us to exploit.

I think all of this is true – and it always makes marketing that much easier when what you are saying is true.

With an increasing amount now being written about short-termism by academics and commentators, I thought it would be interesting to examine some of these ideas in greater depth with reference to recent research (*Part 1*). I will then consider the question of whether this situation will likely persist (*Part 2*). Finally, I will set out how I think one moves from the abstract concept to the practicality of long-term investing (*Part 3*).

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# PART ONE:

## THE PROBLEM OF MYOPIA

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Observation of the fallacy of short-term thinking is not new for economists or psychologists. The famous Stanford Marshmallow test<sup>1</sup>, while used to measure the correlation of patience with life outcomes, takes as its starting point an assumption that impatience or excess discounting of future outcomes is the norm. Marshall’s nineteenth-century economics text *Principles of Economics* noted that short-term thinking is normal behaviour among market participants and people are like “children who pick the plums out of their pudding to eat them at once”<sup>2</sup>. In the early twentieth century, the economist Arthur Pigou described this sort of behaviour as a “defective telescopic faculty”<sup>3</sup>.

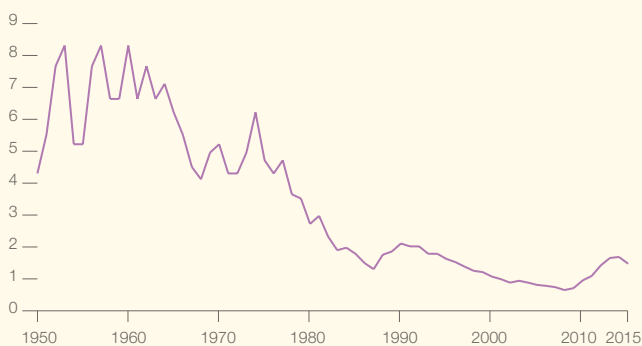
This has been a long-term feature of markets. However, there appears to be some evidence that market participants are becoming increasingly myopic. A study by the Bank of England’s Chief Economist, Andrew Haldane, based on two decades of evidence, appears to show that share price overreaction to near-term news has worsened<sup>4</sup>. In another

paper, he notes that average tenure of CEOs has fallen from nine to ten years to four to five years, while the average holding period of shares has continued to fall<sup>5</sup>.

A lot of the recent research on the subject has also considered the negative knock-on effect of investor short-termism on corporate management behaviour. In his 2006 study, White noted that an excessive focus on earnings per share by investors “leads to management decisions that engineer earnings and drain resources from profitable, longer-term use of the firm’s capital in order to artificially smooth and steadily increase performance”<sup>6</sup>.

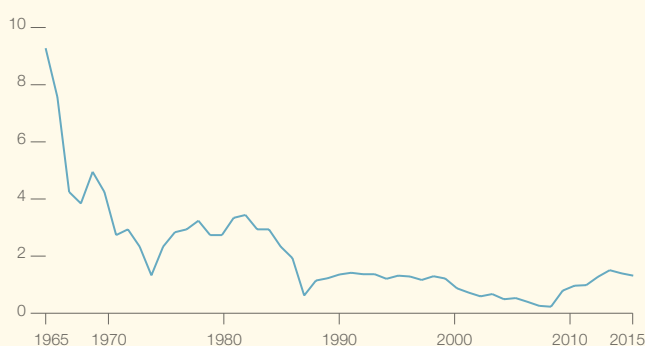
In another study in 2009, Bhojraj *et al* noted that firms that barely beat analysts’ earnings forecasts cut discretionary spending. This avoids the short-run stock price hit associated with missing earnings forecasts but over longer horizons leads to underperformance<sup>7</sup>.

**NYSE average holding period, 1950 – 2015**



Source: New York Stock Exchange.

**FTSE average holding period, 1965 – 2015**



Source: London Stock Exchange.

1. A series of studies in the 1960s and 1970s on delayed gratification carried out at Stanford University.
2. Marshall A. (1890) *Principles of Economics*.
3. Pigou A. (1932) *The Economics of Welfare*.
4. Haldane A. (2011) *The Short Long*.
5. Haldane A. (2011) *Get Shorty* (The Sir Thomas Gresham Docklands Lecture).
6. White A. (2006) *The Grasshoppers and the Ants: Why CSR needs patient capital*.
7. Bhojraj *et al*. (2009) *Making sense of cents: An examination of firms that marginally miss or beat analyst forecasts*.

The two starkest illustrations that short-termism in corporate management is driven by external investors come from a 2014 study based on data from the financial information aggregator Sagemark which demonstrated statistically that “relative to private firms, comparable public firms invest considerably less and in a way that is significantly less responsive to changes in investment opportunities”<sup>8</sup>.

A further demonstration of this comes from a survey-based study in 2005 that found 78% of respondent companies would be willing to reduce discretionary spending on R&D, advertising and hiring in order to meet earnings benchmarks<sup>9</sup>. The authors explain why this may be rational given stock-market-inefficiency and the threat of hostile takeovers, but the message is clear; short-termist markets, driven by what Barton calls “quarterly capitalism,”<sup>10</sup> create a mentality that is damaging for listed companies.

Not only is this bad for the companies involved, it is also bad for the economy as a whole. As the academic Michael Porter pointed out in 1992, the economy is a summation of the fortunes of the millions of companies and individuals that make it up; if most companies make decisions that prioritize the short term at the expense of the long term, we all suffer. Long-term growth and welfare would be the casualty of this interrupted transfer.<sup>11</sup>

The results of short-termism are not a zero sum game where the sensible long-term investor benefits at the expense of the foolish short-term investor, but rather the malign influence of short-termism has the effect of shrinking the overall pie. This is not therefore an esoteric subject for the investment community, this matters for the prosperity of society as a whole.

*–78% of respondent companies would be willing to reduce discretionary spending on R&D, advertising and hiring in order to meet earnings benchmarks.<sup>9</sup>*



While lack of investment and underspending on long-term business development is one result of short-termism, the other is a disregard for infrequent but potentially catastrophic risks. Commentators have described how it makes logical sense (for *homo economicus*) to ignore the low-frequency, high-impact risks to a business if the average tenure of a CEO is under five years. Short periods at the helm, and no comeback for departed executives leads to a mentality that focuses on maximising performance in average years rather than putting in place structures that ensure the business is robust during crises. The outcomes of this are perhaps most obvious in overly aggressive balance sheets, but also in poor contingency planning and, some would argue, in neglect of businesses sustainability from a social and environmental perspective. Short-termism clearly had a part to play in creating the market fragility that led to the global financial crisis. This is evident in Chuck Prince’s famous comment “as long as the music is playing, you’ve got to get up and dance.”<sup>12</sup> Warren Buffett describes such short-termist management risk-taking as “swimming naked.” “It’s only when the tide goes out that you learn who has been swimming naked,” he concludes.

8. Asker J, Farre-Mensa J, Ljungqvist A. (2014) *Corporate Investment and Stock Market Listing: A Puzzle?*

9. Graham J, Harvey C, Rajgopal S. (2005) *The Economic Implications of Corporate Financial Reporting*.

10. Barton D. (2011) *Capitalism for the Long Term*.

11. Porter M. 1992. *Capital Disadvantage: America’s Failing Capital Investment System*.

12. Chuck Prince, Former Citigroup CEO, July 2007.



Let us now turn to what the causes are of these behavioural fallacies:

### CAUSES – EVOLUTION AND PSYCHOLOGY

Research into cognitive biases and behavioural fallacies has increased as a field of academic study. Kahneman's *Thinking Fast and Slow* is an excellent commentary of progress in this field and introduces the concept of *System 1* and *System 2* thinking. (*System 1* thinking is fast, automatic, frequent, emotional, stereotypic and subconscious. *System 2* thinking is slow, effortful, infrequent, logical, calculating and conscious<sup>13</sup>.) We are prone to *System 1* thinking because human evolution has put a premium on the ability to react quickly to dangers or opportunities, but it is also *System 1* thinking that leads to cognitive mistakes when considering complex problems, one of which is investment myopia.

### CAUSES – REGULATORY AND CULTURAL CHANGE

The British economist, John Kay, author of the recent *Review of UK Equity Markets and Long-term Decision Making*, sees the roots of today's excessive corporate short-termism in the changing relationship between investors and management that resulted from regulatory developments in the US in the 1930s. These changes were introduced to address corporate malpractice and corrupt stock promotion. However, these changes led to the rise of an ethos which de-emphasised the relationships of trust and confidence which had been so important to the City of London, replacing them with a reliance on the broad and equitable distribution of information. Kay notes that this approach makes theoretical sense if one believes in efficient markets; all information will be effectively

assimilated by the market and more information disclosure will always improve the functioning of the market. However, the problem is that the efficient markets theory is flawed and was a poor foundation for a new market structure. The relationships between investors and managers (which were removed in the interests of improving the market and increasing 'fairness') actually turned out to be the armature for a functional market. The bloating of the financial industry which accompanied later regulatory changes and deregulation only compounded these problems.

Kay stops short of identifying American-style management pay as a problem. However, it seems likely that the rapid increase in pay differentials in Anglo-Saxon corporates over the last few decades, what Thomas Piketty calls "meritocratic extremism"<sup>14</sup> is likely to be a contributory factor to

13. Kahneman D. (2011) *Thinking Fast and Slow*.

14. Piketty T. (2014) *Capital in the Twenty-First Century*.





## *SOME OF THE MOST SUCCESSFUL AND DYNAMIC WEST COAST AND CHINESE TECH COMPANIES THAT HAVE EMERGED IN RECENT YEARS HAVE INTENTIONALLY INSULATED THEMSELVES FROM STOCK MARKET INFLUENCE*

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short-termist management. Very high remuneration almost unavoidably leads to investor impatience and an unhelpful personalisation of corporate success and failure.

While this is a global problem it is felt more keenly in some markets than others. Meritocratic extremism and short-termist corporate behaviour appears to be at its most extreme in Anglo-Saxon economies. The Managing Partner of McKinsey and co-author of the study *Focusing Capital on the Long Term*, Dominic Barton, notes that, “in my view the most striking difference between East and West is the time-frame leaders consider when making major decisions.”<sup>15</sup> This chimes with my own personal experience as an investor. When I first started looking at the Japanese market in 2007 – Abe had just started his first short unsuccessful period as Prime Minister, ‘Abenomics’

was six years away – I used to be hugely frustrated by meetings with Japanese companies with their lazy balance sheets and focus on other stakeholders. While I still think that the style of corporate management at many Japanese companies leaves a lot to be desired, I also now recognise that the Japanese corporate mentality confers some important benefits. Management pay in Japan is far less egregious than in the West and share creep from options issuance is limited. Creative destruction is not allowed for many uneconomic Japanese businesses or business units because of the social contract with employees. However, for their side of the contract, Japanese workers do not move around as much as employees elsewhere and therefore the costs of retraining and recruiting are reduced. In this way inefficient practice in one part of the economy or organisation, improves efficiency in another part. International expansion is also probably made easier when a workforce has such high loyalty. But more important than this is the fact that Japanese managers do not feel the tyranny of quarterly capitalism as intensely as Western management (their pay and positions are not linked to it, the large domestic shareholders

are not fixated on the short term and in some cases have intercompany loyalties). In many cases, Japanese management can genuinely invest for the long term. I think the development of carbon fibre by the Japanese textile company Toray and Teijin over 20 unprofitable years is one of several good examples of the freedom afforded to companies operating in the Asian model when it comes to the time horizon permitted for investment. The European ‘Rhenish Model’ of capitalism which aims to balance various company stakeholders, I believe can confer similar benefits. At first sight it appears to put shareholders at a disadvantage (non owners and representatives of the workers and local government sit on the board) but the beneficial outcome of minimising existential risks and emphasising sustainability are clear.

It is, I believe, for related reasons that some of the most successful and dynamic West Coast and Chinese tech companies that have emerged in recent years have intentionally insulated themselves from stock market influence with unconventional voting structures or by delaying or avoiding listing altogether.

15. Barton D. (2011) *Capitalism for the Long Term*.

## THE GUARD DOGS OF CAPITALISM?

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### CAUSES – INVESTMENT INDUSTRY FLAWS

In an interview with the British artist and social commentator Grayson Perry, an exuberant London hedge fund manager described professional investors as “the guard dogs of capitalism,”<sup>16</sup> if a manager steps out of line “then we will have you”<sup>17</sup>. It’s a sentiment I agree with, or at least I agree that this is how it should be. Unfortunately the reality is that the investment management industry is not a particularly effective group for policing corporate behaviour. Short-term performance-based-pay, and career progression based on short periods of performance skews fund manager behaviour to ignore the long term to the likely detriment of the companies they invest in and their clients’ performance. The influence of investment banks and brokerages and the surrounding eco-system of consultants, transition managers and advisors who make money on churn in holdings compounds this problem. Other commentators have identified additional flaws related to the power and influence of activists and the stunted capabilities of index funds in assessing and engaging with their holdings. Former chairman and MFS Investment Manager, Robert Pozen notes that index funds own large slugs of the market, however, because of the large numbers of holdings and their limited resources they are not able to engage or vote adequately. In the absence of their own views he argues, they are guided by activists who have much smaller stakes and in many cases much shorter time horizons<sup>18</sup>. Rather like Lennie the physically-giant-but-mentally-childlike character in *Of Mice and Men*, who is manipulated by others to his eventual demise, so the index funds are manipulated by activists who are minnows in terms of their holdings but quick, smart, persuasive and greedy in their actions. The unfortunate consequence of these imperfections is that the investment industry does not end up as some think it should, a group of fierce and focused guard dogs but rather a rag tag collection of mongrels, some so myopic as to be nearly blind, others apparently huge, but in reality, toothless and confused. There is no doubt about it, a lot of the responsibility for market short-termism is driven by flaws in the global financial industry.

16. Grayson Perry: *All Man*. Channel 4. (May 2016).

17. Ibid.

18. Pozen R. (2015) *Viewpoint*, *Financial Analysts Journal*.

## CAUSES – TECHNOLOGY

It is likely that technological developments have been a further contributory factor to financial short-termism. Technological improvements have enabled a proliferation of news through 24-hour TV and online news and chat networks. Software developments and improved computer power have enabled more complex and frequent (albeit probably futile) analysis of share prices and portfolios. Technology has also made it easier not only to trade but to make trading decisions through the use of algorithms. There is however surprisingly little focus on this influence in the recent literature on the subject of financial short-termism, and, on reflection, I would agree that this is fair and technology is not part of the problem. The treatment for short-termism should not be a Luddite rolling back of efficiency improvements that happen to enable our industry-wide bad habits, but rather should address the underlying causes of these habits.

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## *PART TWO – CAN WE CURE SYSTEMIC MYOPIA?*

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There are a number of initiatives afoot seeking to address short-termism: Focusing Capital on the Long Term<sup>19</sup>; Long Horizon Investing<sup>20</sup>; Long Finance Initiative<sup>21</sup> and the corporate governance codes in the UK and Japan are all initiatives which one way or another seek to address myopia in business and the markets. The World Economic Forum, various governments and non-government organisations such as The Aspen Institute have commissioned reports on the subject. Some CEOs have become more vocal on the subject, even in the case of Unilever’s Paul Polman reversing the prevailing policies of short-term guidance “if you don’t buy into this, I respect you as a human being but don’t put your money in our company.”<sup>22</sup> There is no doubt that this is an area that is receiving increasing attention. This raises the question, will these initiatives be successful in removing short-termism? And if so (from a more selfish point of view) does the inefficiency that we exploit disappear?

I think it would be healthy for everyone if we see some sort of improvement. I agree with the argument that investment myopia is bad for business and society, and therefore is not something we should hope to persist or worsen. Even for market participants like us who thrive on some inefficiency, I think there comes a point when it starts to damage the market to the detriment of all participants. I think that the increase in unlisted capital raisings in recent years, while partly down to changing capital requirements is also partly because public markets are seen as a bad influence. Fewer interesting companies choosing to list on public markets is bad for us as (mainly) public market investors. Some improvement in the way in which the industry is measured and rewarded, and the role of brokerages in influencing pricing would be positive.

19. An initiative founded by the Canada Pension Plan Investment Board and McKinsey.

20. A forum run by the Rotman International Centre for Pension Management in Toronto.

21. Z/Yen Group in conjunction with Gresham College.

22. Paul Polman quoted in the FT (Nov 2010) ‘Corporate Plans May Be Lost in Translation’.





That said, I think it is a stretch to argue that even the most energetic initiatives will get rid of myopic behaviour altogether. First, the power of the lobbies and interested parties is such that the process of changing the industry mechanics will be hard work and will take time. Second, the behavioural pitfalls that result in short-termism are down to human psychology and are at least partly the result of the human brain being evolved or optimised for a life that we no longer live. Unlike other drawbacks of our physiology (our propensity to obesity and back problems which I think will be cured by science within a few decades), our psychological and intellectual shortcomings when dealing with complex adaptive systems could only be cured by evolution of the brain. Such evolution would take millennia and would probably never happen because our species has largely stepped off the evolutionary ladder.

So if I were pushed for a conclusion to what is a very big question – will short-termism disappear? I would answer that while there are hopeful signs of a move away from some of the worst short-termist excesses this improvement is a slow process and certain inefficiencies will never be eradicated.

*Some improvement in the way in which the industry is measured and rewarded, and the role of brokerages in influencing pricing would be positive.*

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## PART 3 –

# PRACTICAL LONG-TERM INVESTING

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How do we go about practising long-term investment?

In brief, low portfolio turnover, an assessment of long-term sustainability in our analysis and ongoing engagement with management are prerequisites of long-term investing. In a less abstract way I would suggest that long-term investments can be divided into a few categories. When we invest we look for:

1. **Like-minded companies.** As the preceding paragraphs set out, it is not only investors who suffer from the short-term fallacy, corporates do too. This is counterproductive for companies and ultimately results in poor performance. Research shows that a myopic management style, while damaging to corporate value in the long term, does not result in a discounted valuation. Therefore, truly long-term-minded companies, all else being equal, will increase their value at above average rates and a portfolio of these ‘like-minded companies’ will outperform stock markets.
  2. **Investments where patience is required or to use the brokers’ jargon ‘there is no catalyst’.** These patience based investments I think broadly fall into three subcategories.
    - a. **The transformational growth investment:** the near-term valuation measures look high and while the company is growing handsomely there is a general feeling, and an easily articulated line that ‘it’s in the price’. In such a case, it is possible that by considering the investment on a longer-term view, the scale and duration of the growth opportunity is not fully appreciated by the market. To do this sort of analysis and investing, one has to think about what might happen to the scale of the addressable market or the genesis of future as yet non-existent markets, or how the margin structure of the business could change dramatically once a phase of land grab passes. Traditional brokerage research focused on a two to three year future and reliant on extrapolation of the recent past is not well suited to this sort of thinking. This creates the opportunity.
    - b. **The classical contrarian investment:** the industry is in a cyclical trough, it is out of vogue, the company is in the boring/painful process of managing costs, or may be investing at the expense of near-term earnings, the general tone of management communication is downbeat. It is hard to muster much excitement in these circumstances and difficult to broke the story which means that analyst coverage of the sector dwindles. In this sort of situation, an investor who does not worry if it takes a year or two for the cycle to turn can buy into a decent business potentially at an attractive price. This forms the basis of a contrarian/value/capital cycle style of investing. At its most extreme, this is deep value investing and is not compatible with Baillie Gifford’s growth investing philosophy, but even growth markets and companies go into and out-of-fashion and looking at such areas is one valid style of long-term growth investing.
    - c. **The long runway investment.** There is a third category of stocks which have unusually strong franchises. The market often does not differentiate between truly excellent franchises and average businesses. The value of a franchise which can continue investing and generating high returns for long periods of time is extremely high but I think the market, in its pricing of stocks with similar returns/margins and medium-term growth prospects assumes a homogeneity in business quality. These would be what others describe as franchises with ‘superior fade characteristics’<sup>23</sup>.
- For investment cases in sub categories 2b and 2c I would argue that having the ‘like-minded management’ of category 1 is pretty much a pre requisite. The optimal case, of course, is for an investment case to qualify for multiple categories of long-term investing; that is when we should get really excited.

23. Chancellor E. (2004) Capital Account: A Fund Manager Reports on a Turbulent Decade, 1993-2002.

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# CONCLUSION

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*Myopia is a problem for businesses and investors and leads to poor business decisions and inefficient markets. It does however, create an opportunity for investors who are willing and able to invest with a truly long-term view. We are well placed as an organisation to exploit this inefficiency. While there is increasing public attention from government and non-government organisations on the negative impact of short-termism on companies and markets, and steps are being taken to correct some of its distortions, it is unrealistic to assume that markets will ever be completely cured of their myopia. In practical terms, when seeking to invest on a long-term basis, we should look to invest in like-minded companies. In particular, in situations where patience is required either because the large profit opportunity will take several years to realise or because the market does not appreciate the superior franchise characteristics of the business.*

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