A LONGER-TERM APPROACH

HOW WE CAN STICK TO OUR RESOLVE

ACWI Alpha Team. First Quarter 2018

BAILLIE GIFFORD

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A LONGER-TERM APPROACH – HOW WE CAN STICK TO OUR RESOLVE

ACWI ALPHA TEAM

Since the days of the Babylonian Empire, the New Year has been a time for resolutions. The Babylonians' favourite resolutions were apparently to pay off their debts and return farm equipment they had borrowed. Now we vow that we will exercise, read and give more; eat, drink and complain less; stop smoking; start volunteering. But we generally don't – a British survey in 2007 found that 88% of all resolutions end in failure. Apparently we have plenty of resolutions, but not much resolve.

Of course we all know that, for those in the Northern Hemisphere at least, it's partly a matter of timing. It's tough taking more exercise and eating less comfort food just when the days are short and cold. Indeed Australian surveys suggest slightly lower failure rates – but only slightly lower. So our resolution issues must be less to do with the weather and more to do with us, and in particular our lack of will power.

Financial crises, thankfully, come around less often than January 1, but they come around often enough and prompt plenty of resolutions – and those resolutions, many of them centring on being less short-term in our outlook, turn out to be just as flimsy.

In May 2005, William Donaldson, then the chairman of the Securities and Exchange Commission, addressed the CFA Institute conference. Donaldson, co-founder of an investment bank and a former chairman of the New York Stock Exchange, laid out a number of issues of concern to the SEC but then turned to what he called a "more fundamental problem that, in my view, affects multiple aspects of America's corporations and securities markets. It is the tendency towards a short-term outlook shared by management, investors and financial analysts."

Memories of the accounting and corporate governance scandals of the late 1990s, the stock market crash of 2000 and the subsequent protracted bear market were still fresh, yet Donaldson was almost apologetic about raising the issue – "I realize that speaking out on the need for a longer-term approach to investment analysis is akin to speaking out in favor of baseball, hot dogs, and apple pie – it's something almost everyone supports…" But it was what he said next that was the really important bit – "… in an abstract way". It's something that almost everyone supports in an abstract way.

Just how abstract is shown by the aftermath of our most recent financial crisis. We again find ourselves reflecting on the state of shareholder capitalism and lamenting our inability to embrace a long-term view. Jim Sinegal was one of the co-founders of Costco, one of the great entrepreneurial success stories of modern America. When he stepped down as CEO he reflected on 26 years' involvement with a public company – "One of the follies of American business is that we are all so tied in to these quarterly results and having to perform that it's damaged a lot of businesses." (Emphasis added). And it's very far from being just an American problem. The Kay Review, commissioned by the UK government, concluded in 2012 that "short-termism is a problem in UK equity markets", while stock market turnover rates remain elevated relative to long-term historic averages almost everywhere.

Each crisis reminds us of the benefits of taking a longer-term investment approach. For individual market participants, such an approach is clearly contrarian and likely therefore, for good or ill, to produce distinctive results. It turns the inherent

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volatility of share prices to the investor's advantage by offering them the opportunity to own more of a good business at a better price. Finally, making fewer decisions tends to raise the quality of those decisions and placing fewer trades definitely reduces the costs. At a system-wide level, we might avoid the damage done to so many businesses by short-termism: the corners cut, the opportunities foregone. In the process, we might even generate greater innovation and wealth and more stable and satisfying employment.

Why then, if the advantages are so clear and the reminders of those advantages so frequent, do we resist a longer-term approach so strongly and so persistently? More than 75 years ago, when the average holding period of stocks in America was much longer than it is today, John Maynard Keynes answered this question with characteristic elegance – "…life is not long enough; human nature desires quick results, there is a peculiar zest in making money quickly, and remoter gains are discounted by the average man at a very high rate."

Less elegantly put, we like a fast buck and we are hard-wired to be short-termist. This has a lot to do with our reactions to stress which have evolved remarkably little since our remote ancestors, even long before the Babylonians, walked the plains and tried to dodge predators. When threatened, our blood pressure rises, our short-term memory improves and we put aside all thought of long-term projects. These are useful responses when faced with a lion, but they're a good deal less useful when faced with falling share prices or a quarter's bad performance, the modern fund manager's perceived sources of danger. If anything, it has become ever easier and more painless, in the near term at least, to give in to stress as market liquidity has increased and trading costs have fallen.

These responses, and the rapid turnover that they help spur, are so entrenched, so essentially human that we strongly suspect that after the next crisis, whatever the resolutions and reforms made in the interim, we will again find ourselves lamenting our short-termism and searching for answers.

We think there are some concrete steps that investment managers can take to mitigate stress reactions, overcome our instinctive human short-termism and so take the first steps on the path to better investment results and a healthier investment ecosystem. They revolve around accepting our human frailties and creating an institutional environment that reduces the likelihood of stress responses and encourages a longer-term perspective.

First, we can reduce our exposure to sources of stress. An admittedly rather small survey of fund managers in 2007 found that 80 per cent of them checked their funds' performance at least once a day, even though almost all of them acknowledged that such activity was futile, addictive and tended to exaggerate their mood swings. One answer is to switch off the Bloomberg, but a more important one is to focus investors on the longer term view by lengthening performance measurement periods and aligning incentives with them.

Second, while you can reduce exposure to sources of stress, you can't eliminate stress altogether. One way to reduce its impact is to work in teams. Studies of rowers have shown that those who row in crews have higher pain thresholds than those who row alone. But, more importantly, different people are stressed by different things at different times. As long as your team is reasonably diverse, you stand a good chance of not all being stressed at the same time and so you reduce the chance that the team as a whole will react to stress rather than reason.

Third, investment managers should be independent. Running your own business, rather than taking orders from a remote headquarters, means that you can change incentives and working practices, as outlined above. But just as importantly it also means that you come to understand increasingly intuitively that real businesses, such as the ones in which we invest, aren't about smooth quarterly earnings progressions, that they constantly need to invest now, depressing near-term earnings, in order to produce long-term results. This may have been part of what Ben Graham, the father of investment analysis, meant when he wrote that "Investment is most intelligent when it is most business-like." Warren Buffett has said that these are the most important words ever written about investment.

CURIOUS ABOUT THE WORLD