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Avoiding Short-Termism in Investment Decision-Making

ASFONZ/Women in Super
Auckland, Wellington, August 2006

Jack Gray

Sponsored by

Tyndall

Presentation

Agenda

- *Excessive* short-termism *is* a sin
- Where does short-termism develop?
- *All* participants bear some guilt
- Long-termism has *some* benefits and advantages
- 5 steps to getting to and exploiting the long-term

Short-Termism Can Be Costly



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Sustainable Growth At Risk Through Excessive Short-Termism

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THURSDAY 21 OCTOBER 2004

The Business Council has called on Federal and State Governments and the private sector to consider a range of measures to counteract excessive short-termism in Australia.

The recommendations are part of a BCA Paper *Beyond the Horizon: Short-Termism in Australia*, which examines the prevalence and types of short-termism in Australia's public and private sectors.

The Paper, which is part of the BCA's 2004 Annual Review released this week, highlights a number of areas where short-termism has the potential to create major problems in sustaining growth.

Long-Termism Can Be Costly

www.timesonline.co.uk

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Analysis

June 29, 2005



Robert Cole COMMENTARY

What's wrong with short-termism anyway?

ARGUMENT about short-termism in the City has raged for lengths of time that would make the most ardent long-termist proud. Messers Hanson, White and Green fed the fire in the 1980s. The antics of Slater Walker and Tiny Rowland made it a hot topic of conversation in the early 1970s.

It is still raging, thanks to John Sunderland, chairman of Cadbury Schweppes and president of the CBI, and the riposte launched yesterday by Tony Watson, a man with as good a right as any to be called Mr Institutional Investor.

COMPANY SEARCH

Enter company name

Summary

WORLD MARKETS

Europe America Asia

FTSE 100



Index	Value	Change
FTSE 100	5,271.10	↑ +0.01%
DAX	4,850.82	↑ +0.17%
CAC 40	4,442.90	↑ +0.47%

▶ More market data

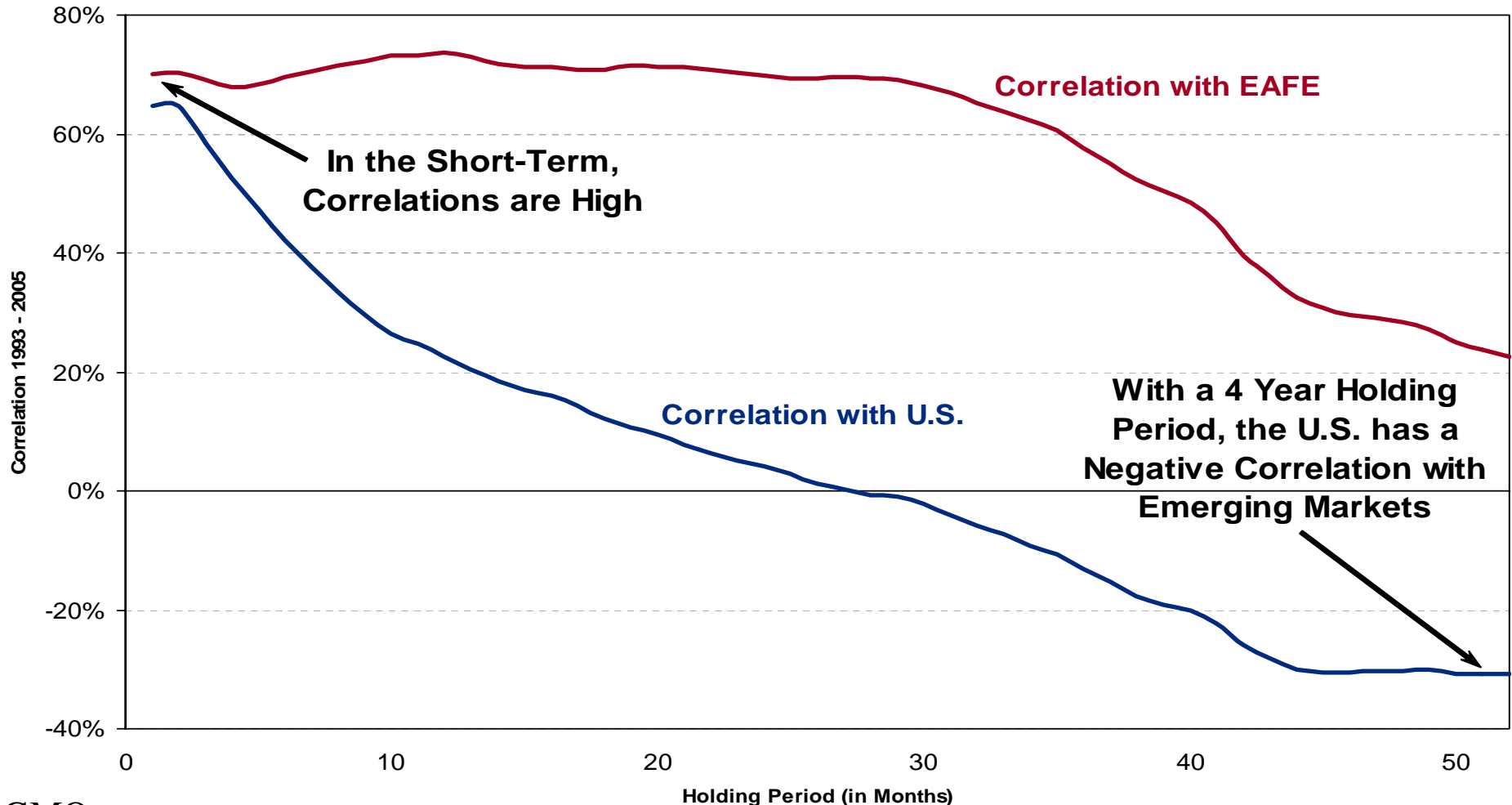
Delayed by 15 minutes
Data from Hemscott

Excessive Short-Termism *Is* a Problem

- Distortion of opportunities
- Churning destroys wealth
- Substantial value permanently destroyed in extremes
- Momentum investing: *Private Gain, Public Cost*

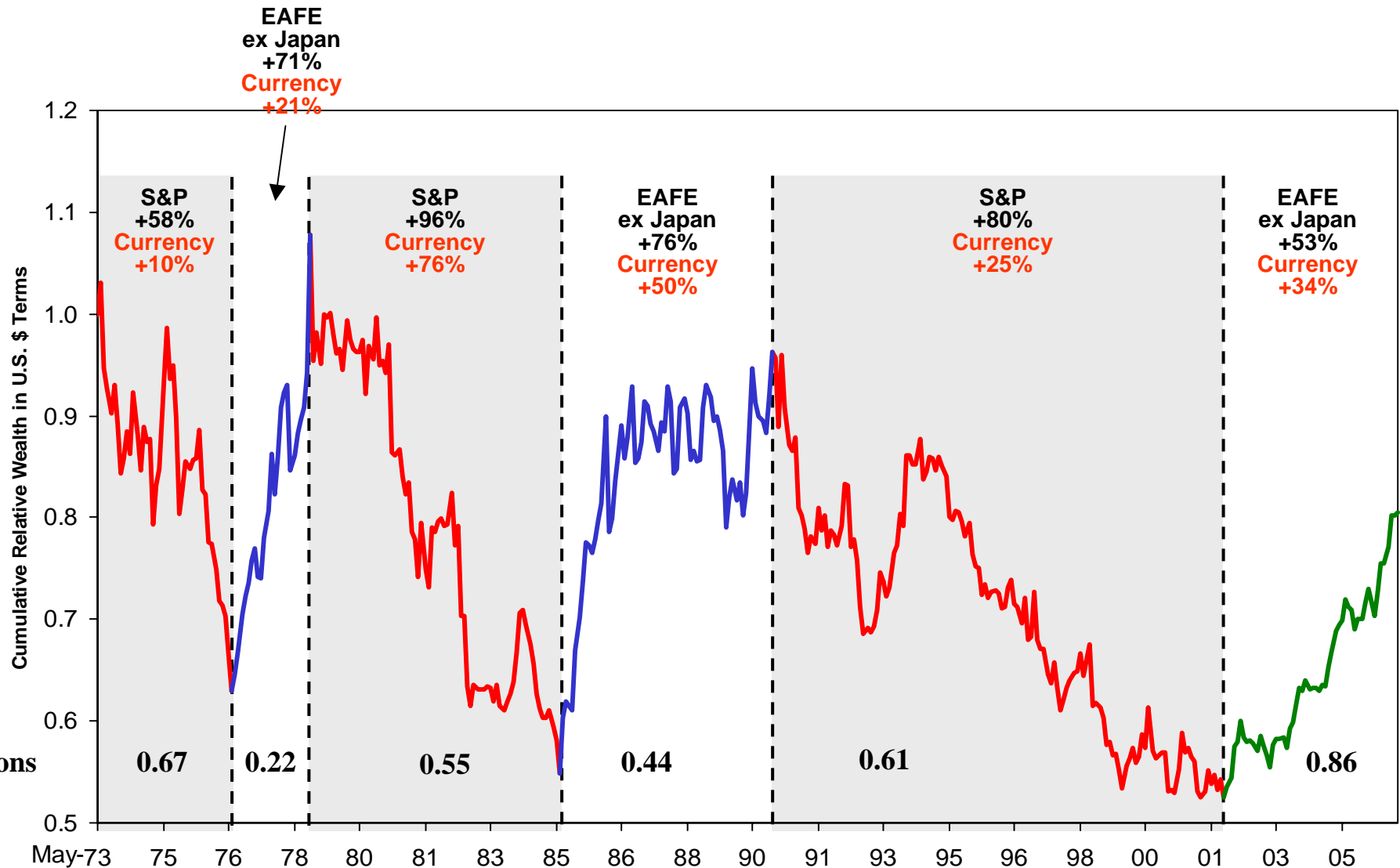
Lies, Damned Lies and Correlations...

Correlations Between Emerging & Developed Equities



Correlated, Yet Huge Swings

EAFE ex Japan vs. S&P 500

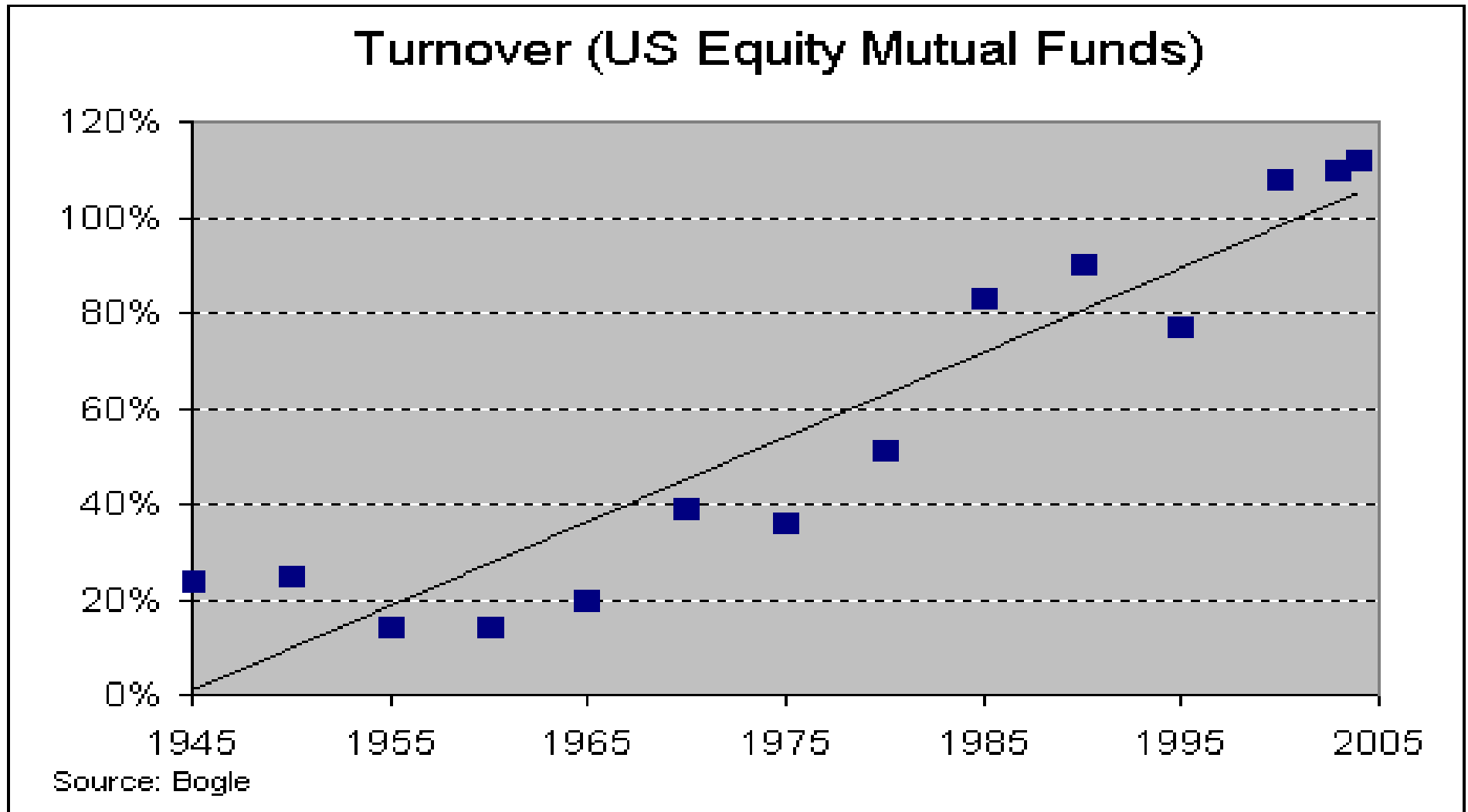


Correlations

GMO

Note: Excludes Japan Source: GMO, Standard & Poors As of 6/30/06

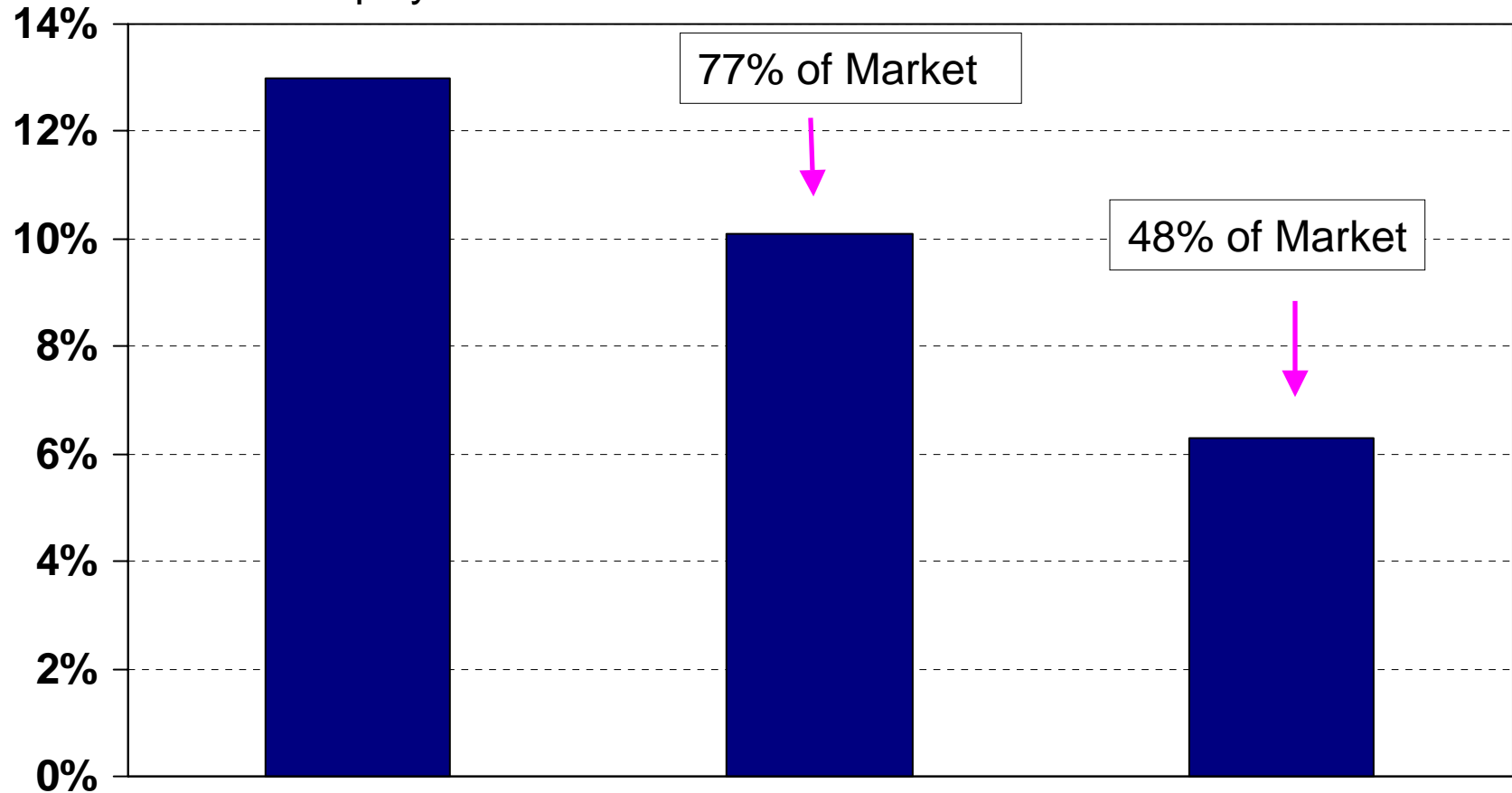
Ever Shorter Short-Termism



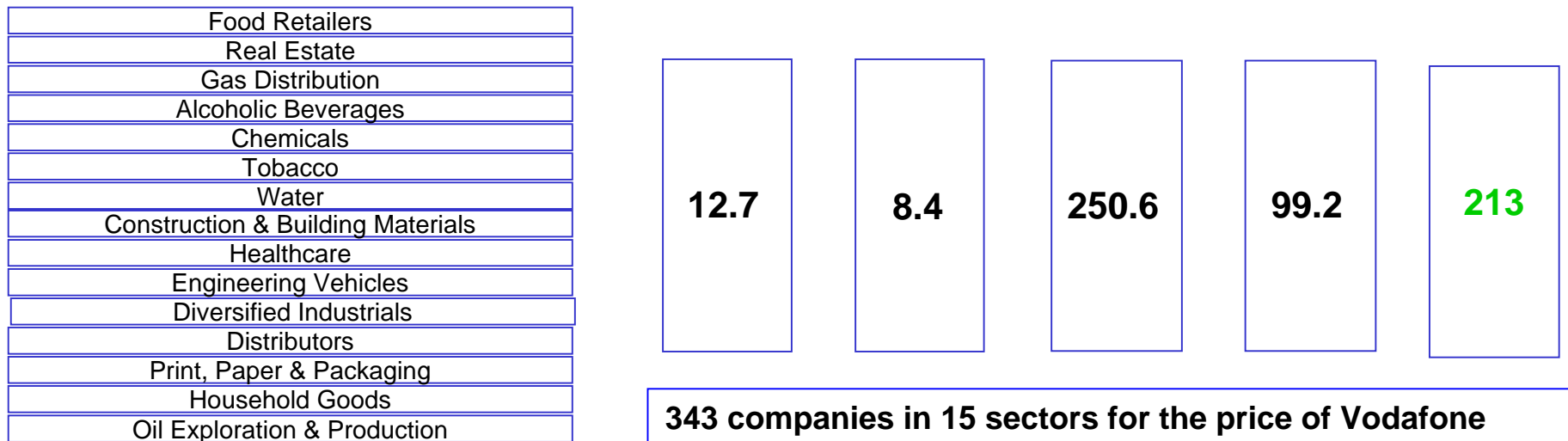
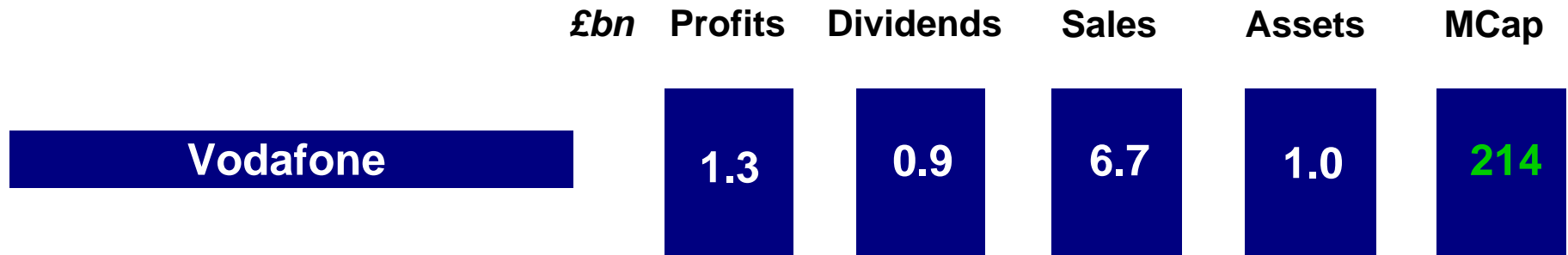
Churn, Baby, Churn

'Value' Chain: Market \longrightarrow Fund \longrightarrow Investor

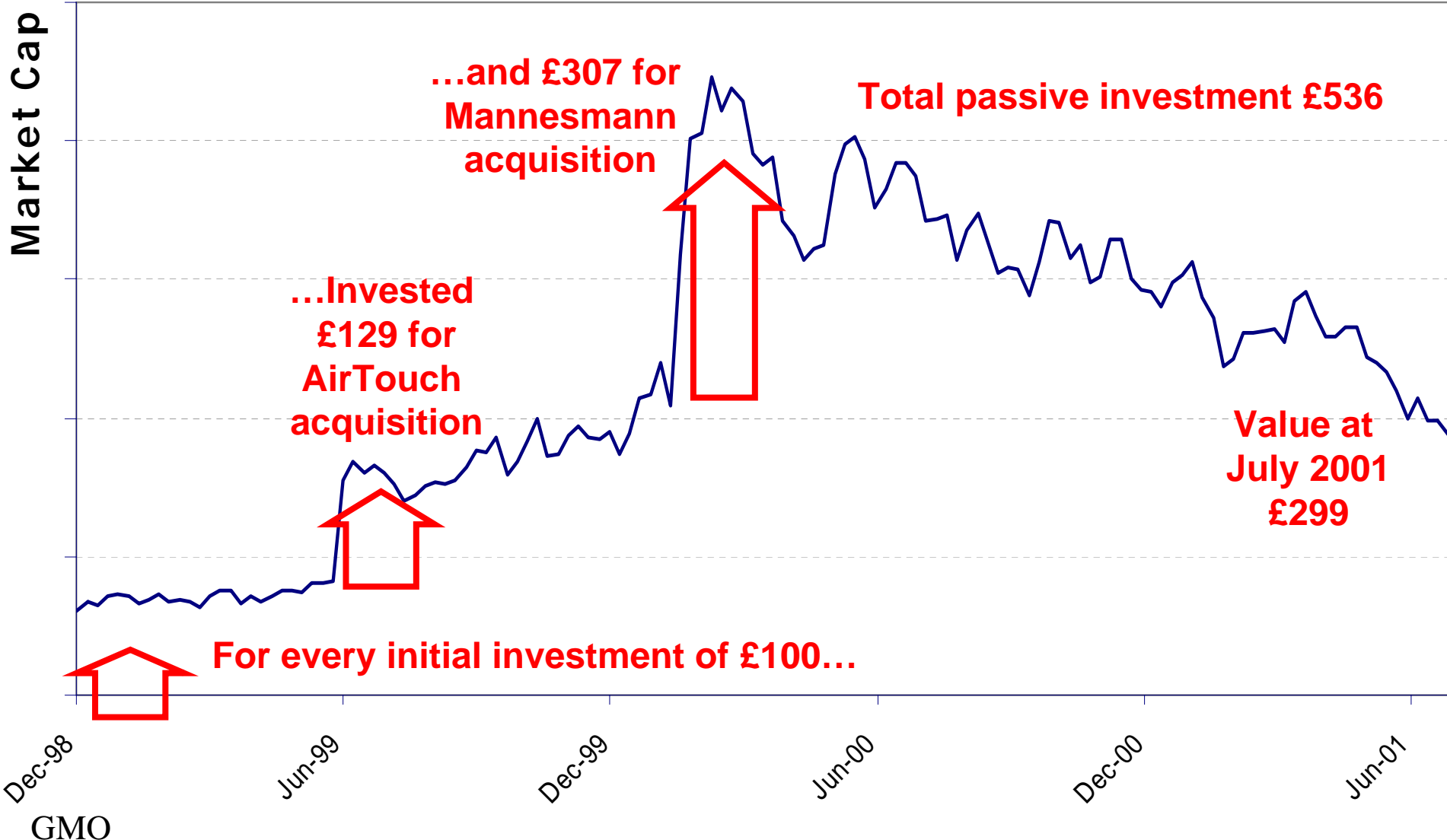
US Equity Mutual Fund Annual Returns 1983–2003



Short-Term Valuation



Value Destruction/Transfer ... Vodafone



20 Largest Global Stocks: 1980

IBM



AT&T

Exxon Mobil



Royal Dutch



Amoco



Schlumberger



Standard Oil



Mobil



Chevron Corp



BP



Atlantic Richfield



General Electric

General Motors

Texaco Inc



Shell T&T



Eastman Kodak

Halliburton Co



Phillips Petroleum


















Gulf Corp.





Marconi



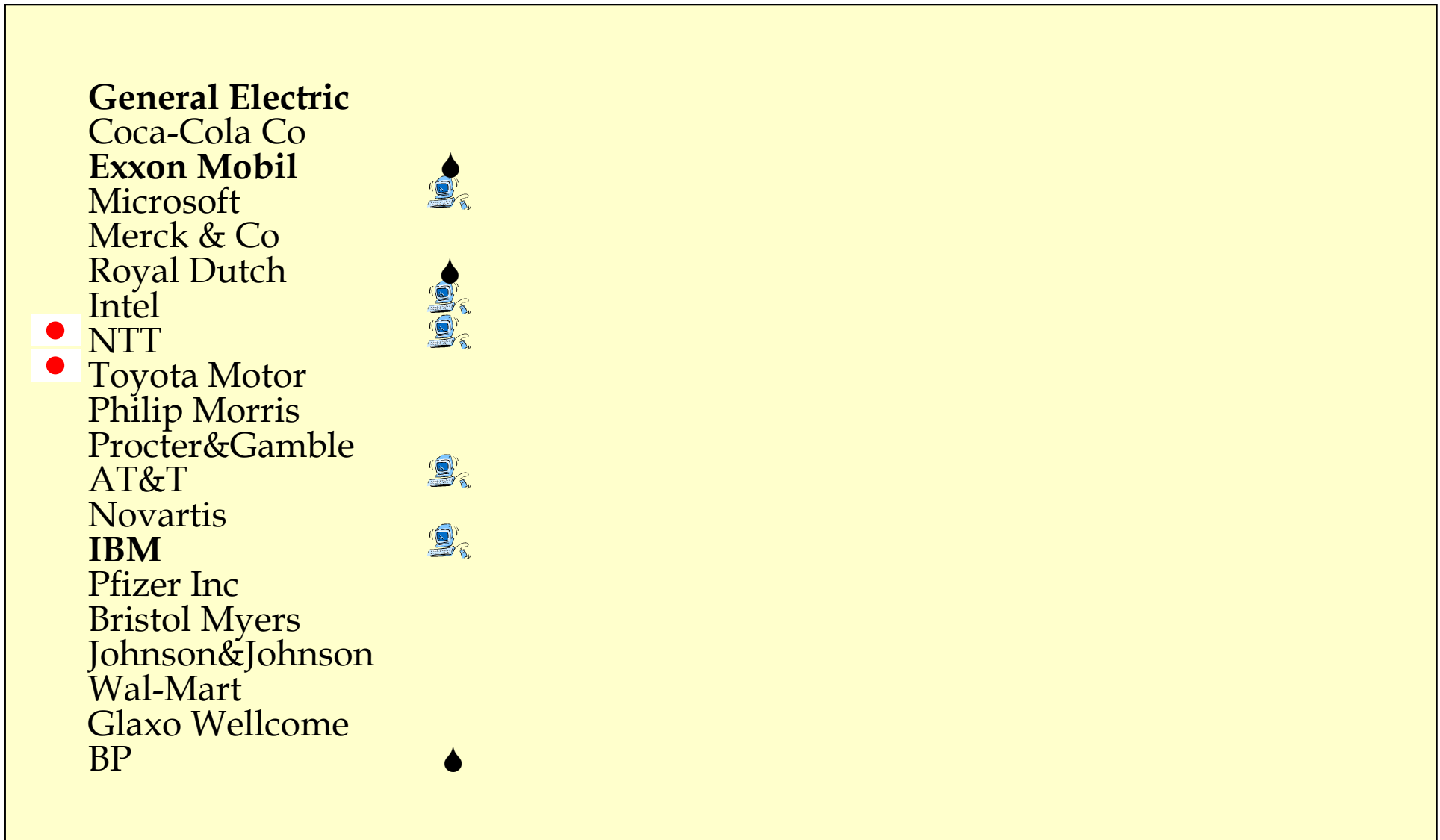
20 Largest Global Stocks: 1985

IBM	
Exxon Mobil	
General Electric	
General Motors	
AT&T	
Shell Oil	
 Sumitomo Bank	
Amoco	
 Dai-Ichi Kangyo	
Royal Dutch	
 Toyota Motor	
 Fuji Bank	
Du Pont (E I)	
 Bank Tokyo-Mits.	
Sears Roebuck	
Schlumberger	
Eastman Kodak	
 Sanwa Bank	
Mobil	
 Matsushita Elec	

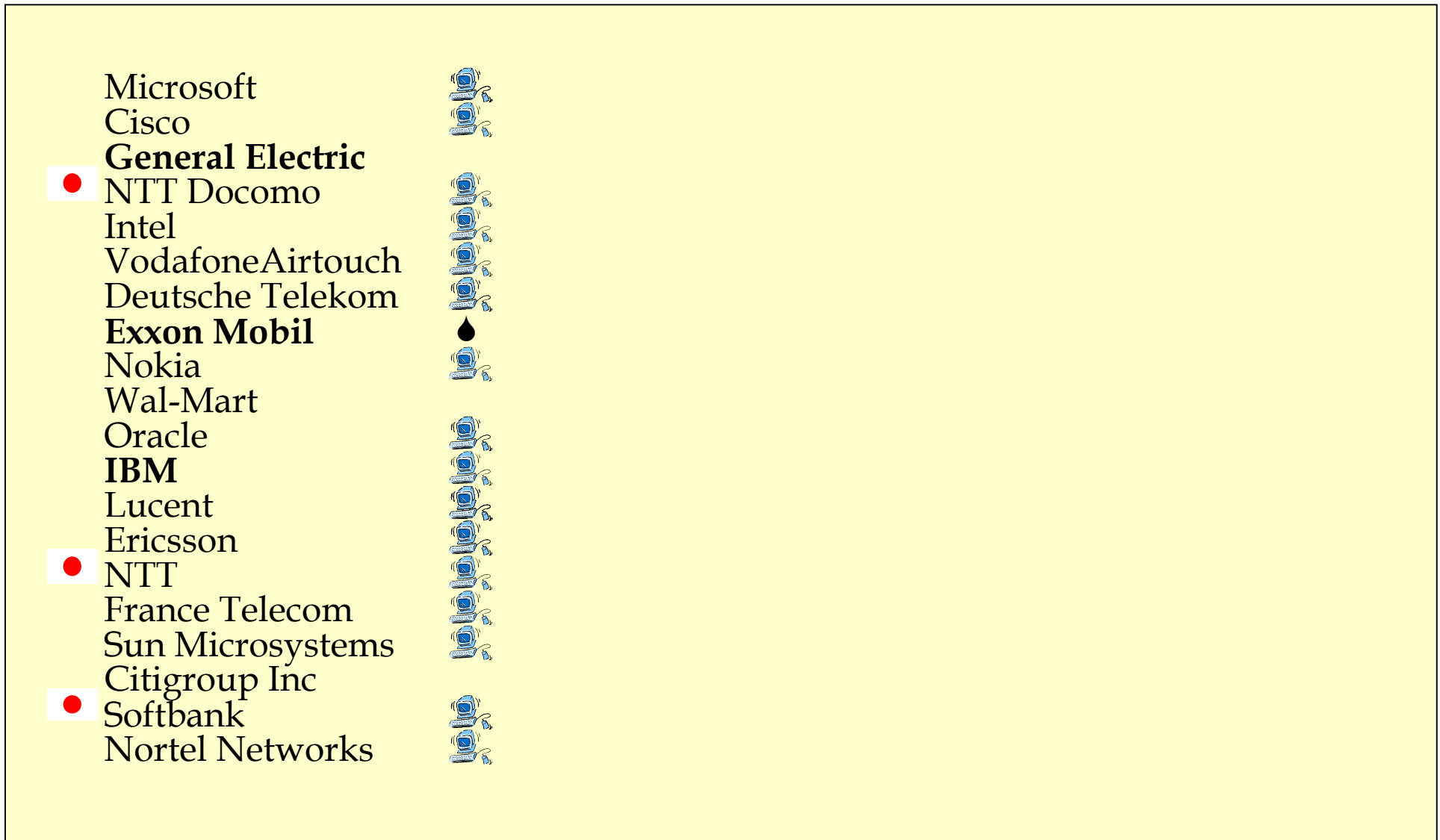
20 Largest Global Stocks: 1990

- NTT 
- Industrial Bk Japan
- Sumitomo Bank
- Fuji Bank
- Dai-Ichi Kangyo
- Bank Tokyo-Mits.
- **Exxon Mobil** 
- **General Electric**
- Tokyo Electric
- **IBM** 
- Sanwa Bank
- Toyota Motor
- AT&T 
- Nomura Securities
- L-T Credit Bank
- Royal Dutch 
- Philip Morris
- Nippon Steel
- Tokai Bank
- Sakura Bank

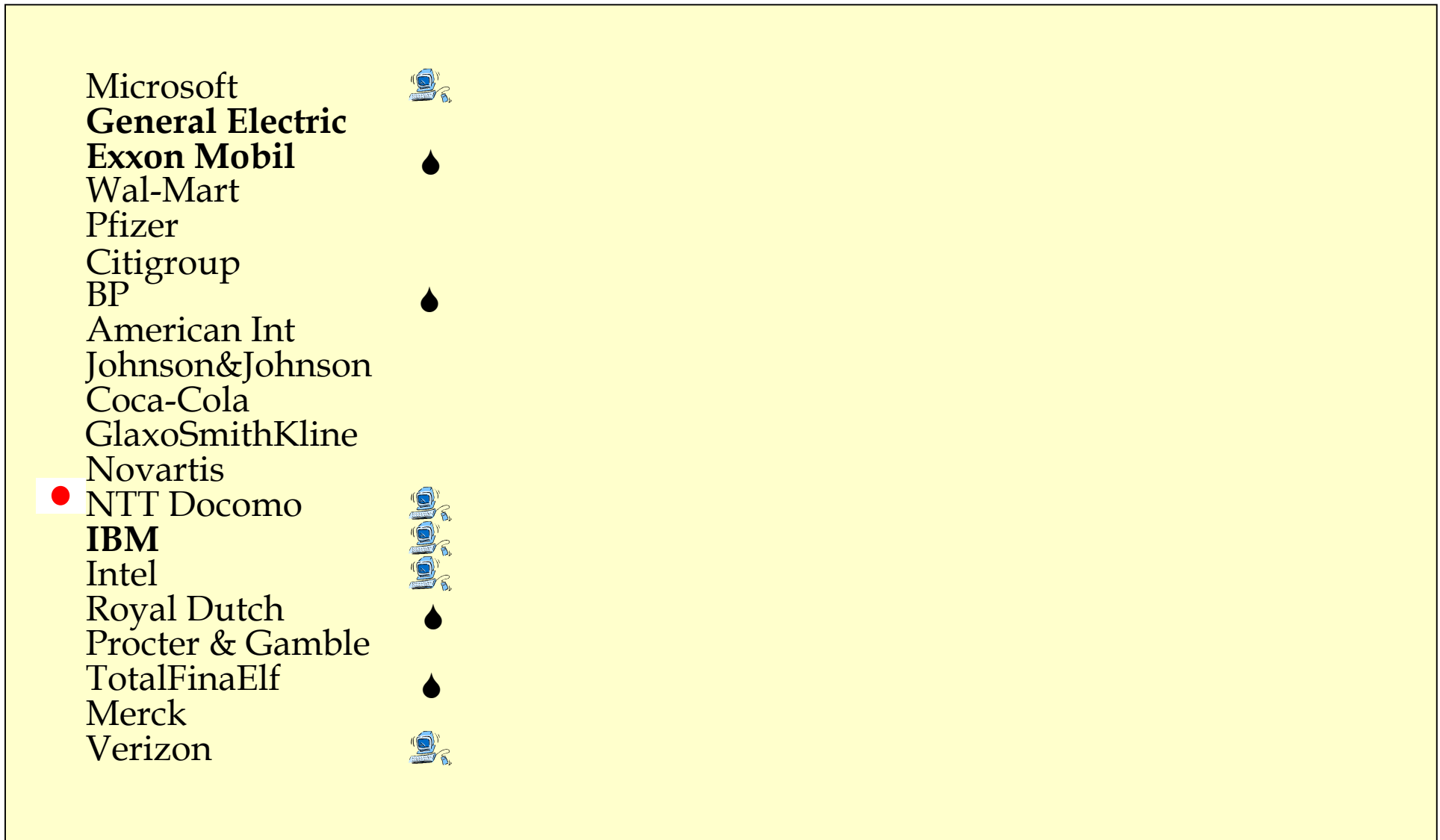
20 Largest Global Stocks: 1998



20 Largest Global Stocks: March 2000



20 Largest Global Stocks: June 2002



20 Largest Global Stocks: June 2005

General Electric

Exxon Mobil

RDS

Microsoft

Citigroup

BP

Pfizer

Wal-Mart

Johnson & Johnson

Bank Of America

HSBC Holdings

Intel

Vodafone

American Intl

Total

Glaxosmithkline

Saudi Basic Inds

Altria

Novartis

Procter & Gamble



We're All Guilty

Scurrilous Survey (2004)

Player	Guilty of Short-Termism?
Media	89%
Government/Regulators	81%
Financial Planners	81%
Consultants	68%
Members	64%
Trustees/Fiduciaries	53%
Investment Managers	27%
Corporations/Analysts	N/A

Principal-Agency Frictions

	Participants' Horizon
> 30y	Members' <i>intentions</i> ; Actuaries; Nuclear Decomm
10y	Very few; Academics
1–3y	Members; Mgrs; Cons ('Long' review); Fiduciaries; Co's; Regulators; Governments
Q/M	Co's; Analysts; Cons (Regular reviews); Mgrs (Reports, Sales); Media
< Wk	Media; Traders

So Is Long-Termism Virtuous?

*“... to make the purchase of an investment permanent might be a useful remedy for our **contemporary** evils. For this would force the investor to direct his mind to the long-term prospects and to those only.”*

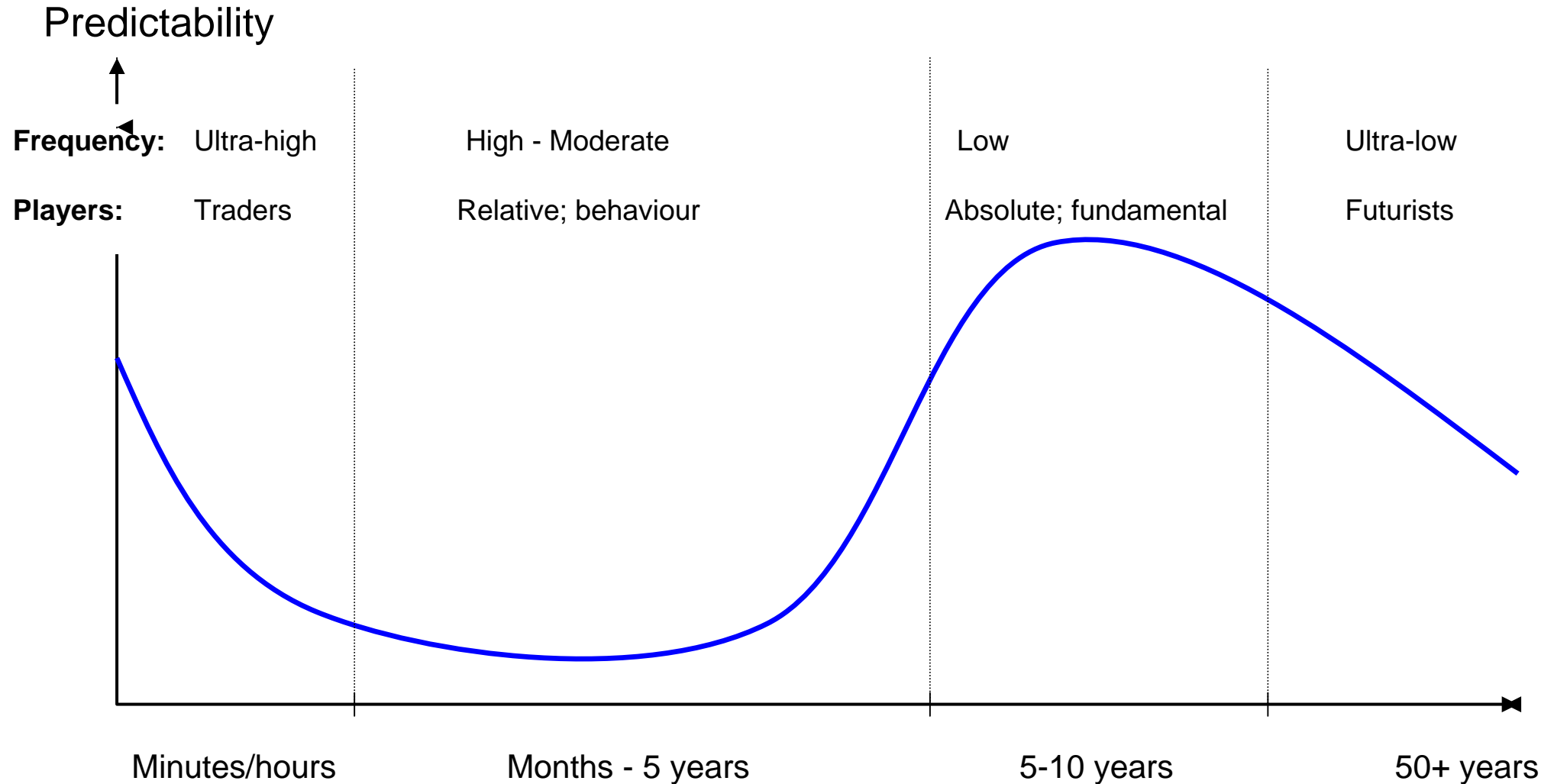
“ ... it is the long-term investor, he who most promotes the public interest, who will in practice come in for most criticism...”

John Maynard Keynes (1936)

Long-Term Advantages

- Slight predictability

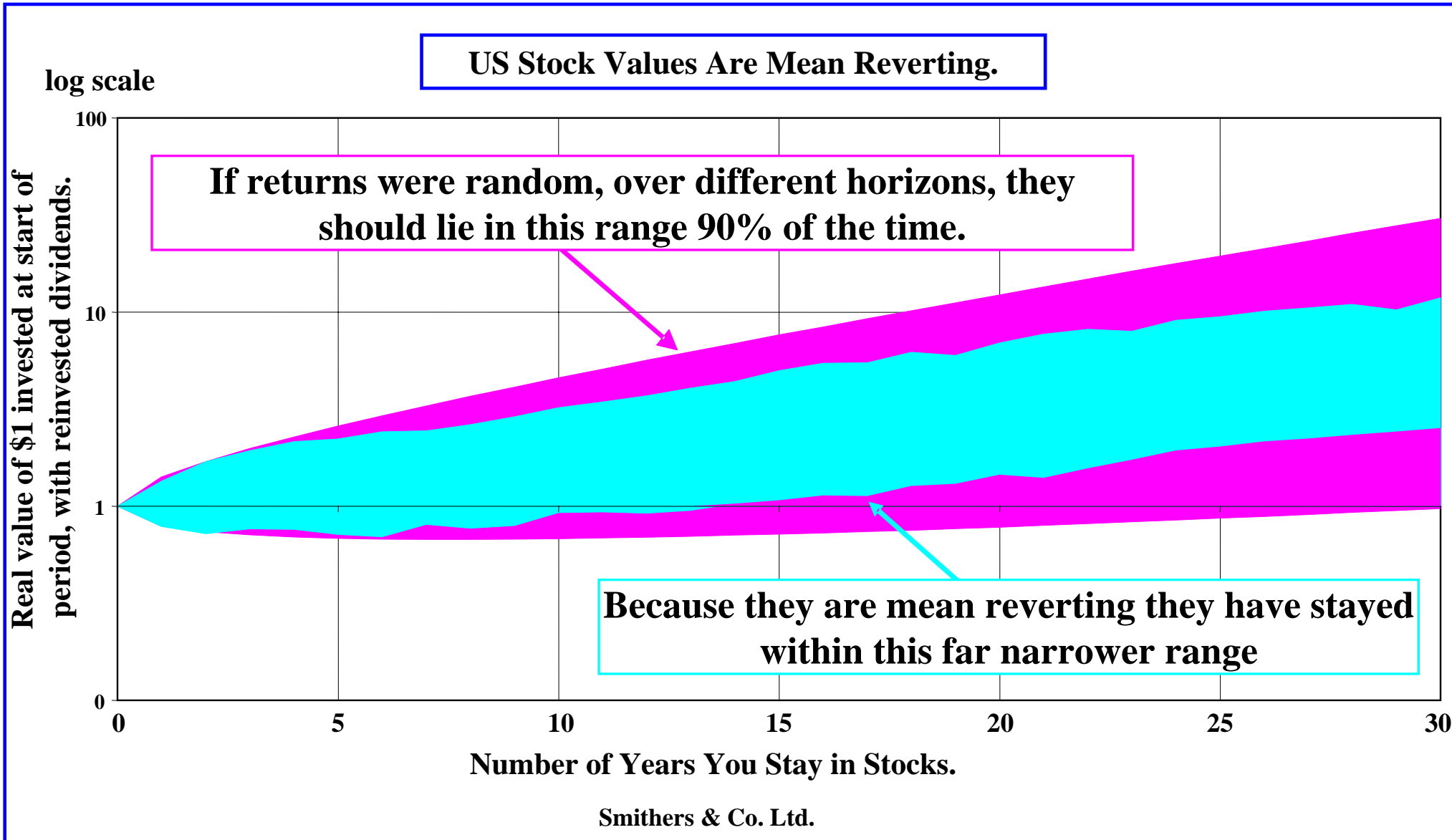
Predictability vs Horizon? (Stylised)



Long-Term Advantages

- Slight predictability *Via Mean Reversion*
(L/T pricing models: DDM, Bonds, Alternatives)

Mean Reversion in Action



Long-Term Advantages

- Slight predictability *Via Mean Reversion*
(L/T pricing models: DDM, Bonds, Alternatives)
- Lower risk?
 - Yes, match 'intentions' horizon
 - Depends, annualised volatility decreases, but ...
- Lower turnover → Lower (certain) costs
- Minimal competition: Limits to arbitrage

Yes, but

- Neither panacea for nor paragon of investment virtue
 - VHF hedge funds
 - 25 vs 75 year-old
 - Disposition effect
 - Institutional AA *too* long-term?

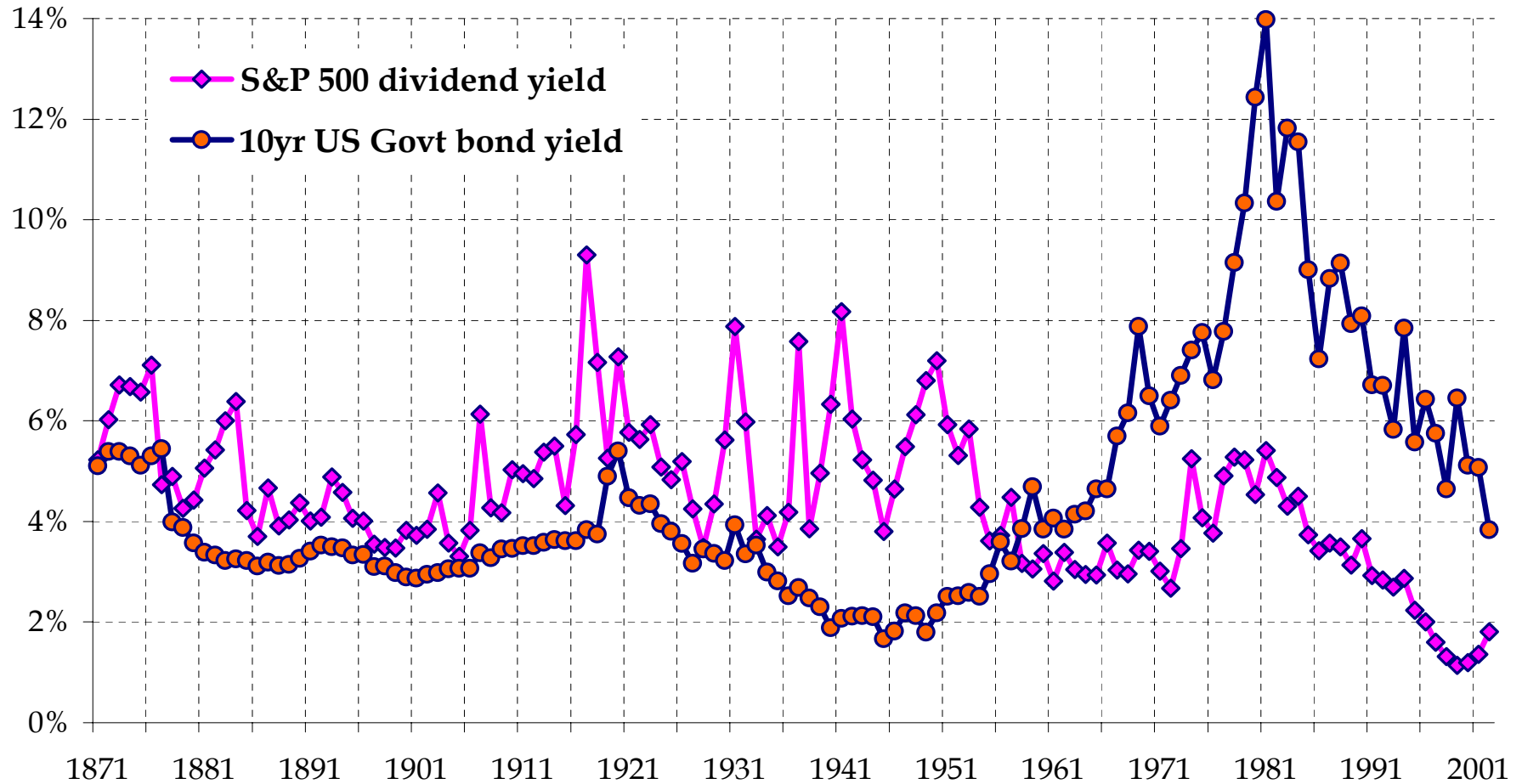
Yes, but

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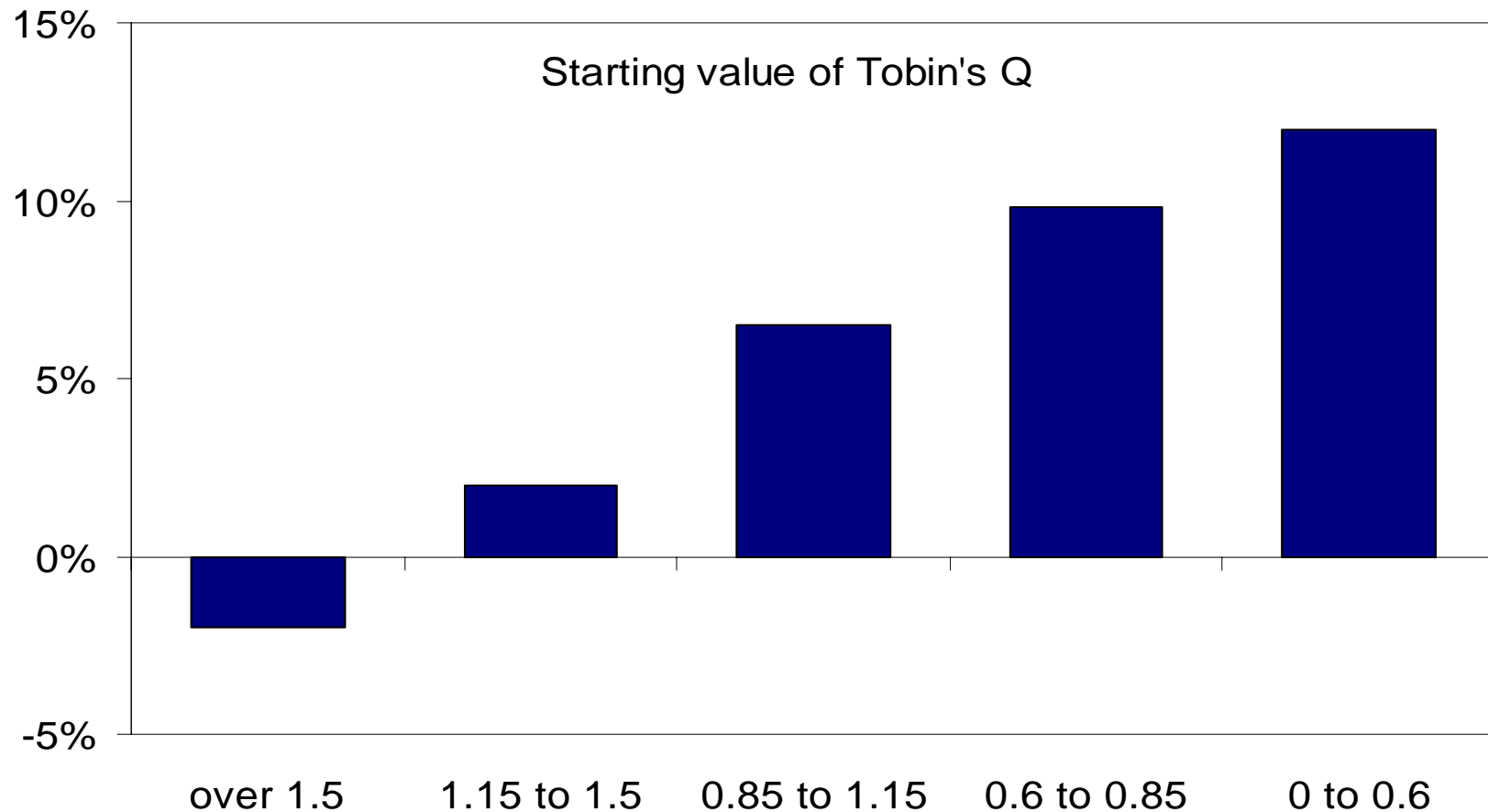
“... It is not wise to look too far ahead; our powers of prediction are slight, our command over results infinitesimal ... ”

That guy Keynes again!

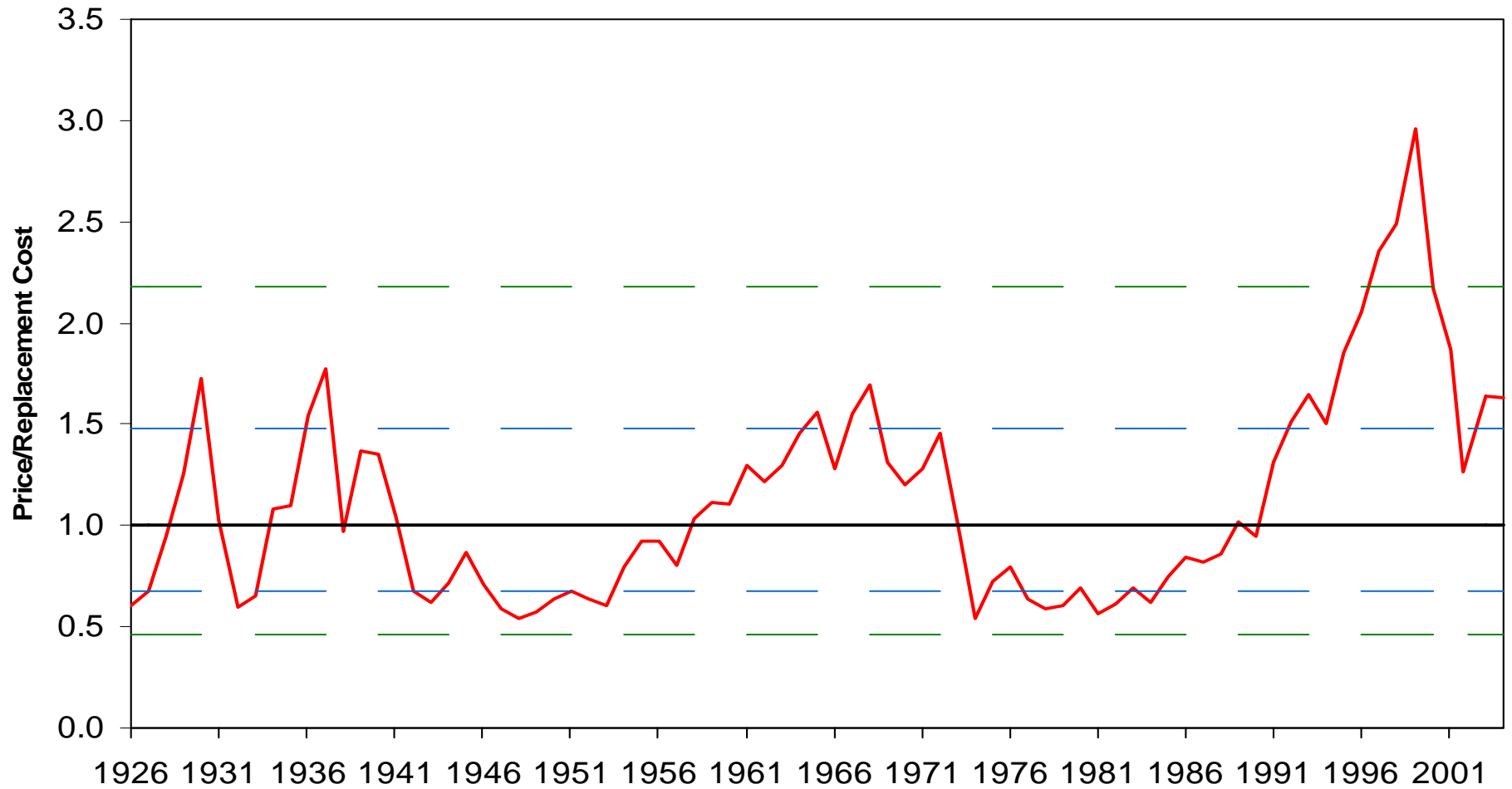
“Predictive Powers Are Slight...”



10y Real Return 'Slightly' Predicted by Q



But Can You Wait This Long?



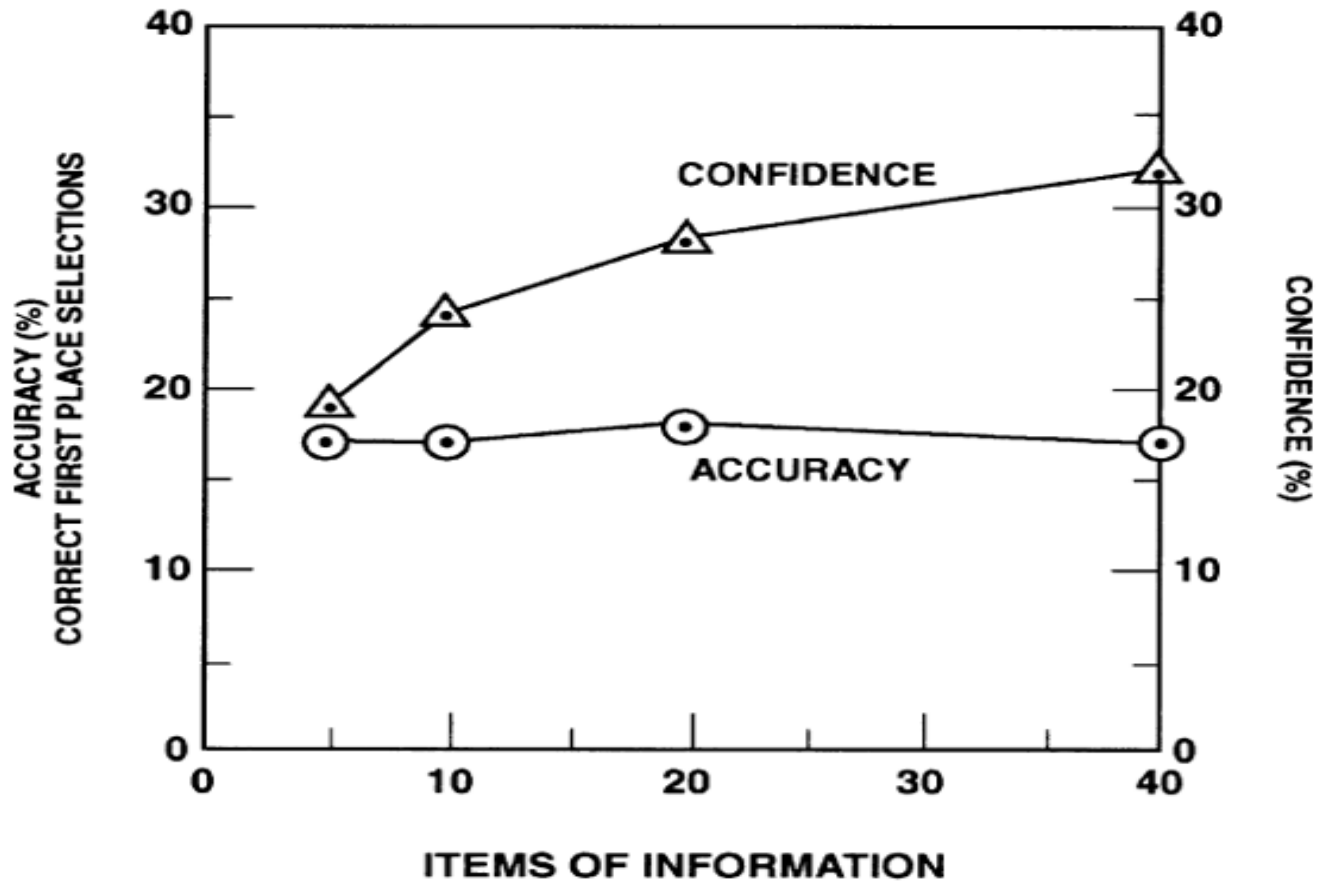
We're Not Just *Homo Economicus*

*“An exclusive concern with the long-term may be prescriptively sterile, because the long-term is not where life is lived. **Utility cannot be divorced from emotion ...***

*A theory of choice that completely ignores **feelings** such as the pain of losses and the regret of mistakes is not only descriptively unrealistic, it also leads to prescriptions that do not maximise the utility of outcomes **as they are actually experienced...**”*

Danny Kahneman

The Enemy Is Us



5 Steps to Long-Termism

1. Recognise and struggle against barriers:
 - *Cognitive*: Re-read the masters
 - *Temperament*: Training?
 - *Institutional*: Incentives matter

5 Steps to Long-Termism

1. Recognise and struggle against barriers:
 - *Cognitive*: Re-read the masters
 - *Temperament*: Training?
 - *Institutional*: Incentives matter

2. Use anchors of long-term value-added:
 - Rhythms of history
 - Human psychology (individual and group)
 - Slight predictability

5 Steps to Long-Termism

3. Be selectively sensitive to the short-term but avoid Gresham's Law of Investing

*“Comforting short-term, urgent drive drives out **discomforting**, long-term important information”*

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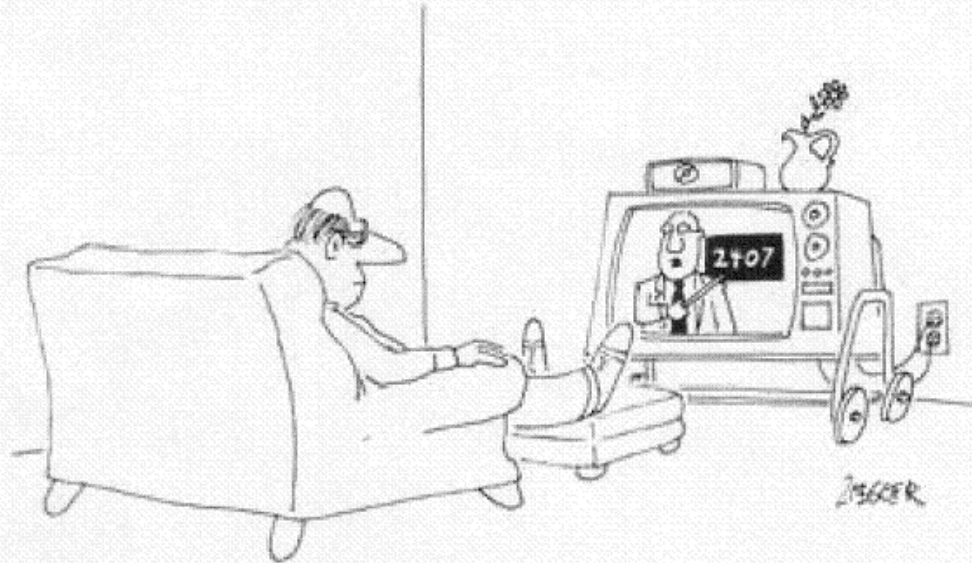
Through long periods of sustained thinking hedge the ‘Pascal trap’:

“All man’s miseries derive from being unable to sit quietly in a room alone.”

Blaise Pascal, c.1630

Drivel, Drivel Everywhere...

THE COMPLETE CARTOONS OF THE NEW YORKER



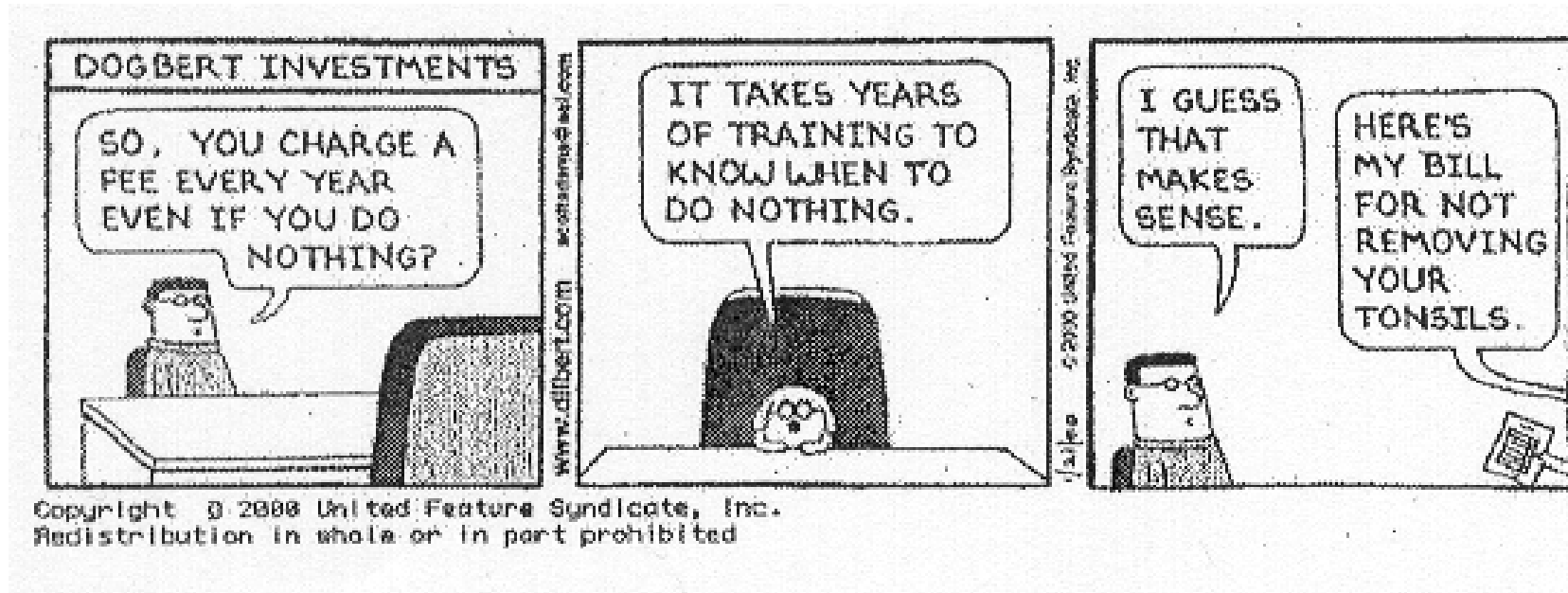
*"Today's number is two thousand four hundred and seven.
That's sixteen above normal for this date and thirty-eight
ahead of last month at this time."*

Jack Ziegler (6/3/1985)

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Thoughtful Inertia



5 Steps to Long-Termism

4. Develop small number of strategic partnerships with appropriate managers, consultants, funds
 - Kultur is Kritical
 - Mandate flexibility
 - * 10-year mandates; closed-end funds
 - * Well-structured PBF
 - * Question turnover and agency effects

5 Steps to Long-Termism

5. Develop and use *Investment Beliefs*including a *Long-Term Investment Statement*:

- Charter of decision-making
- Estimates of risk-tolerance (relative, absolute, liquidity, ..)
- Tolerance for *explicable* underperformance
- Exposure to long-duration alternatives
- Emphasise 'sustainability?'

Avoiding Short-Termism (*Fin*)

- *Excessive* short-termism *is* a sin
- *All* participants bear some guilt
- Long-termism has *some* benefits
- 5 steps to getting to and exploiting the long-term
- Have courage and wisdom

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