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What does it mean to be a (genuine) Long Term Investor?

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Campbell Macpherson, business advisor to Sovereign Funds and Institutional Investors and author of new business book, 'The Change Catalyst', a 2017 Wiley publication, discusses what it means to be a Long Term Investor, busting some industry myths along the way …

As the industry contemplates the implications of record-low interest rates, the rising popularity of so-called Smart Beta, brewing real estate bubbles, plateauing public market valuations, a sclerotic infrastructure investment ecosystem, nervousness over emerging market debt, the fact we haven't had a recession for almost a decade and a deluge of capital surging into private markets looking for higher returns … institutional investors are naturally taking a closer look at their strategy and re-setting stakeholder expectations in light of the challenging investment environment.

One question in particular is vexing asset owners and asset managers alike:

What does it mean to be a Long Term Investor?

Almost every single asset owner I have met says they are a long term investor (in much the same way that every CEO automatically declares that their greatest asset is their people) – but what does that actually mean? Let's take a look at some common misconceptions about investing for the long term…

Busting some myths about long term investing

Myth #1: The definition of 'long term' depends upon your investment horizon. Too many discussions on this subject have become bogged down in circular debates about timeframes. 'How long is long term?' is not a question upon which to dwell for very long. Yes, for some investors, 'long term' can be 10 years, for some 30, for others multi-generational.

But this debate is a distraction. I recommend we agree that long term investing must be of a duration of at least one investment cycle (7-10 years) and could be as long as several generations … and swiftly move on.

Myth #2: Long term investing means "hands off the tiller". While one aspect of long term investing may indeed be staying calm during a downturn, Long Term Investors are not complacent. If we are not careful, investing for the long term could be used as an excuse for inaction or poor short / medium term performance.

"It's OK, we are in it for the long haul" shouldn't be used to gloss over investment decisions that turn out to be poor with the benefit of hindsight. Performance setbacks are actually an opportunity to

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reflect and learn. "What caused the setback? Could it have been foreseen? Could we have done anything differently? Should we amend our research or decision-making processes in light of this new insight?" Rather than attaching blame to previous investment decisions, let's learn from them.

Myth #3: Long term just means following the index. This is closely aligned to myth #2. Obviously passive investing is an important part of every institutional investor's armoury and it is often a politically safe way to invest large sums of money, but indices are far from perfect. They are snapshots in time. The companies in the main indices are selected on the basis of today's market capitalisation rather than an overt assessment of their sustainability or longevity. I also wonder if the tidal wave of capital that has been pouring in to index funds these last few years has over-inflated the share prices of the markets' largest companies?

One of the reasons behind the flow towards passive funds has been the relatively poor net performance of so many active funds over the preceding few years. While fees are always stated as a reason for moving out of active funds, it does appear that many institutional investors have been switching because of <u>short-term</u> performance, which makes little sense. Once the tide inevitably turns, passive investors could be leaving money on the table. Long Term Investors expect their active managers to under-perform some years – but over-perform in the long run.

Myth #4: Long term means investing in 'illiquid' assets. Some investors point to their investment in the so-called 'illiquid' asset classes of Real Estate, Private Equity and Infrastructure as proof that they are a Long Term Investor. It isn't. The inclusion of these asset classes are simply indications of a diversified portfolio.

I also question precisely how illiquid these asset classes really are. There is an excess of capital waiting to be deployed in these asset classes. Bloomberg reports that the Private Equity industry has $1 Trillion of "dry powder" on its books - cash sitting idly in the wings. This equates to 22% of the global funds under management in that asset class. There are plenty of other investors willing to buy your stake on active secondary markets if you ever need to sell.

As a Long Term Investor, we are investing for the long term across every asset class – not just in these three. Locking up capital in a real estate project or a PE fund should be no different to locking up capital in publicly listed stocks. The fact that you could sell your public market equities at the drop of a hat doesn't mean you should – or will for that matter.

Undoubtedly, one of the many advantages of Private Equity is that it enables company boards and management to take a longer term view rather than become distracted by the burden of quarterly reporting mandated by listed stock exchanges. But as Long Term Investors, we need to work against such short-termism anyway. Long Term Investors take a long term view of the companies they invest in – no matter whether they are privately held or publicly listed.

Myth #5: Long term investing means activism. Views concerning the impact of activist investors on the long term value of companies are polarised. Some pundits claim activist groups are disruptive short-term investors that aim to achieve a short-term spike in share price by cutting costs through slashing staff numbers and R&D spend. Others claim that activist investors provide the catalyst that complacent companies need to sharpen up and prepare for the future. Exponents of either group can find credible academic analysis to support their point of view.

Most activist investors often tout that they have the long term interest of the shareholders at heart, which is patently not always the case. One example is Kraft Heinz's failed attempt to buy Unilever earlier this year. Under the leadership of Paul Polman, Unilever seems to have become the model of responsible capitalism with a "sustainable living plan" that was applauded by NGOs and activist groups and a move away from stultifying quarterly reporting. Kraft Heinz seemed to have viewed the company as "ripe for selling off assets, stripping out the fat and increasing the dividend," according to John Sauven, executive director of Greenpeace UK. Yet the plan was abandoned after just days as hostile approach to such a "good" company would have been too damaging to the reputation of both Kraft Heinz and Warren Buffett, one of its big shareholders.

Myth #6: The long term is really just a series of short terms. This is a half myth as it is obviously true in a very literal sense. It is certainly true that an extra dollar gained, or even saved, today will be worth several dollars after decades of compound growth. But the inherent short-term nature of the statement is fraught with danger.

As McKinseys and FCLT Global (Focusing Capital for the Long Term) demonstrated in their excellent Feb 2017 white paper, *'Measuring the economic impact of short-termism'* (www.fcltglobal.com), far too much shareholder value is being lost by the corporate world's obsession with quarterly reporting cycles and an unwillingness to invest in R&D and building capability for future growth. The market capitalisation of Long Term US companies grew $7 billion more than that of other firms between 2001 and 2014.

While it may indeed invest in individual trees, a Long Term Investor also needs to be able to look up and see the forest.

So what does it mean to be a Long Term Investor?

Here are my top ten:

1. It is about attitude.

Being a Long Term Investor is about attitude, not timeframes. It requires a confidence based on clarity of purpose, clarity of the outcomes that the organisation requires, clear research and insightful analysis. A Long Term Investor is bold enough to speak up about the dangers of short-termism and brave enough to address the issue within their own organisation.

2. **Culture is key.**

Do your investment professionals behave like Long Term Investors or are they still overly concerned with quarterly/half-yearly/annual performance? How do you remunerate them? Are their bonuses tied to 1, 3 or even 5 year performance results? If so, you may be perpetuating short-term thinking. One Sovereign Fund pays 50% of their PM's bonuses on how well they display long-term behaviours. This is indeed an excellent step in the right direction.

3. As is leadership.

And, of course, culture starts at the top. What behaviours do your leaders display? How do they react to short-term performance hiccups? Do they continue to invest during such periods? Do they review major decisions to see what could be done better next time? Have they clarified what it means to be a Long Term Investor and made this relevant and applicable to each investment department?

Culture change requires clarity and true leadership. True leadership requires genuine engagement with your people.

4. Long term mega trends.

Our world is changing at an unprecedented rate. The 'new economy' minnows of 20 years ago are now the biggest corporations in the world and have disrupted entire industries. The entire gains of the S&P 500 in 2015 were equivalent to the gains of just four stocks – Facebook, Amazon, Netflix and Google. Some say we live in uncertain times; confusing uncertainty with change, which ironically is a certainty.

In fact, we can be completely certain about several long-term trends that will affect the way we all live and invest:

- The world's population has increased 5 fold since 1900 to more than 7 billion. It is forecast to reach 9 billion in 20 years' time.
- Average human life expectancy has increased from 31 to 71 (80+ in the West) in that same period and is set to continue its upward trend thanks to advances in biotechnology and genetic medicine.

- An explosion in livestock is devastating our land, destroying our rain forests, poisoning our oceans and warming the planet. Fossil fuels and plastics are making the situation worse.
- People are swarming into urban areas.
- New energy sources are being developed at a rapid rate.
- Globalisation has disrupted entire industries and, when combined with global political complacency, has created a large under-employed underclass in the West.
- AI and Automation is set to make this look like a picnic. Ray Kurzweil, futurist and a director of engineering at Google predicts that, by 2029, "the manufacturing, agriculture, and transportation sectors of the economy will be almost entirely automated". We could add financial services, the legal profession, accountants and even doctors to that list. Computer programmes can now diagnose cancers from X-Ray images more accurately than some of the best oncologists.

How does your organisation capture and analyse long term trends – and more importantly, how does this insight manifest itself in your investment strategy?

5. Execution is paramount.

It doesn't matter how big your research department may be. It doesn't matter how many clever macro-economists you hire or how many technology, political, sociology or environmental experts you have on tap, if your organisation isn't ready, willing and able to deliver – it will all have been a complete waste of time and effort. *Strategy without execution is a daydream*. (The other half of this pithy saying is also valid – *Execution without strategy is a nightmare*.)

6. A Long Term Investor is an <u>Engaged</u> Investor.

Long Term Investors invest in companies that are likely to be around for the long term. They invest in companies with sustainable business models and long term strategies.

They invest in companies that deliver value for the entire ecosystem in which they operate - employees, suppliers, partners, customers and their communities. Companies that operate purely for the benefit of their shareholders and senior executives are not sustainable in the long term.

Long Term Investors invest in companies that understand the value of R&D and invest in building long term capability. Long Term Investors engage with the organisations in which they invest; either avoiding companies who are obsessed with short-term reporting or working with them to change. Even predominantly 'passive' Long Term Investors can encourage corporations to start acting and thinking long term – for the benefit of their shareholders, employees and customers alike.

7. Fight against short-termism.

Long Term Investors speak out against short-termism, realising that the battle may be a long one but that winning is critical.

Short-term thinking is ingrained in the investment industry. At a recent long-term investing conference, the CEO of a large pension fund was talking about the new S&P Long-Term Value Creation (LTVC) Global Index and went on to mention the fact that the first six months' performance was not stellar but that the index had rebounded in its second six months. The irony of the moment was not lost on the audience. When one of the most vocal exponents of long-term investing feels compelled to defend the 1 year performance of the new long-term index – we have a long journey ahead.

8. Long Term Investors plan to be around for the long term.

This may sound like a Blinding Glimpse of the Obvious but Long Term Investors also need to be sustainable themselves. This requires:

a) strategic clarity (clarity of purpose, measurable outcomes based on objective analysis, clarity of comparative advantages, clear investment principles and investment strategy, clarity of accountabilities, clear governance and decision-making processes, …),

b) clarity of financial liabilities and future cash flows, and

c) a sustainable business model that is as cost-effective and productive as possible.

How well does your organisation measure up against these criteria?

9. Take advantage of downturns.

Long term companies are brave enough to be counter-cyclical. If a leadership team believes in its business model and strategy, the best time to invest in people development, R&D, advertising and market-share building activities is during a downturn. The same philosophy is true for Long Term Investors. If you are clear about your investment principles and genuinely believe in your investment strategy, the best time to invest is in a downturn.

Do you possess the liquidity to not only cover your liabilities but to 'double down' when markets dip? Do you have the corporate will to be counter-cyclical?

10. Synergistic partnership with your asset managers.

Obviously, switching asset managers due to short-term performance is not in line with a genuinely long-term investment strategy. Measuring performance over 1, 3 or even 5 years also makes little sense – if you are a Long Term Investor.

Perhaps the best way to select your long-term asset managers is to judge them on many of the same factors above – on attitude, culture, leadership, how they remunerate their investment professionals, how engaged they are with the industries and companies in which they invest, how they take advantage of long term trends, the clarity of their firm's investment strategy and whether their company lives and breathes it, their own financial sustainability, how they react in a downturn and whether their interests are aligned with yours.

After all, asset owners and asset managers alike want to partner with genuine Long Term Investors.

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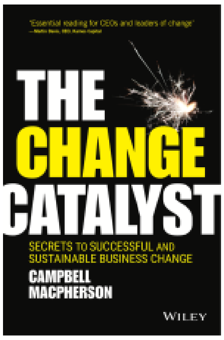

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