# Lengthening the investment time horizon

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## IN BRIEF

Investors are increasingly short term in their orientation, even while demographic trends point to longer life expectancy and the need for larger pools of retirement funds.

Various reasons have been posited for this short-term view. They include the role of incentives, media and financial reporting and numerous decision-making biases identified by behavioural researchers.

An arbitrage opportunity exists for managers with a longer investment horizon – there are more opportunities for differentiated performance when holding securities for longer time periods.

## INTRODUCTION

> The spectacle of modern investment markets has sometimes moved me towards the conclusion that to make the purchase of an investment permanent and indissoluble, like marriage, except by reason of death or other grave cause, 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.
> – John Maynard Keynes

One wonders what Keynes would make of the investment environment today given the short-term view that characterises so much of both individual and institutional investor behaviour. We now live in a world in which people are living longer and in need of retirement funds with a longer shelf-life – and yet, paradoxically, investors are typically more short-term in their focus than ever.

A review of the data clearly reveals the short-term nature of much investment behaviour today. Stocks are being held for record-short periods of time, and professional investment managers are generally also taking a short-term view in their management of assets. Wall Street's research coverage is focused on near-term corporate earnings rather than on sustainable earnings growth over the medium term. Moreover, markets have a tendency to overreact to short-term events, particularly missed quarterly earnings estimates, and this fosters the quarterly earnings frenzy.

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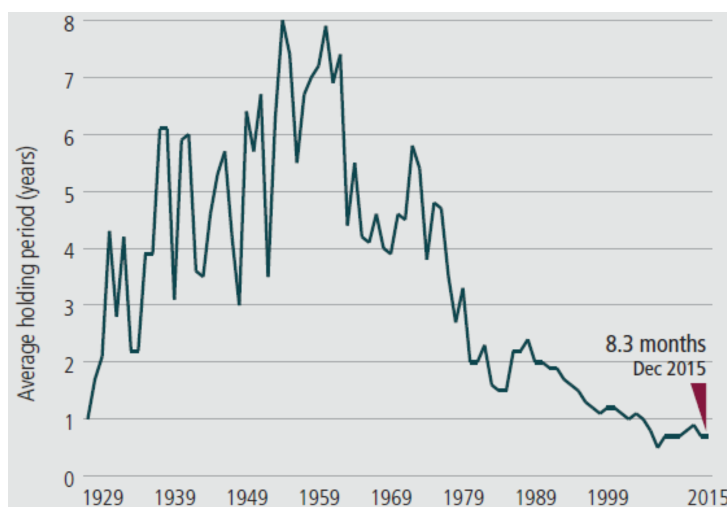
The financial media is paid to manufacture market noise and has become an over-revved engine in constant need of fuel. In addition, the structure of compensation incentives in the investment management industry further encourages the short-term focus - a surprisingly large number of investment professionals have less than half of their compensation based on longer-term performance measures.

As discussed in this paper, there is a time horizon arbitrage opportunity in the marketplace, which managers with a disciplined investment process can capitalise on. Company fundamentals do not change nearly as much as equity market prices, and herein lies the opportunity for investors with a longer-term view. Numerous market players concur with this view. For instance, CalPERS (California Public Employees' Retirement System pension fund) published its 10 investment beliefs. Among them is the belief that "a long term investment horizon is a responsibility and an advantage" that leads them to "favour investment strategies that create long-term, sustainable value."

## THE SHRINKING TIME HORIZON IN THE MARKET

Stocks are being held for shorter periods than at any time since the 1920s, as the New York Stock Exchange (NYSE) average holding period data shown in Figure 1 reveals. On average, a stock is being held for approximately eight months. This reflects investment transactions driven by both individuals and institutional investors. Until the 1970s, the investment landscape was largely dominated by wealthy individuals and families. This has since changed markedly, with professional investors now accounting for the largest share of investment activity, though it should be noted that these professionals manage significant mutual fund asset pools that are driven by retail investors.

Figure 1: Investors are holding stocks for shorter time periods
NYSE average holding periods (1929 - 2015)




Sources: Ned Davis Research, December 2015.

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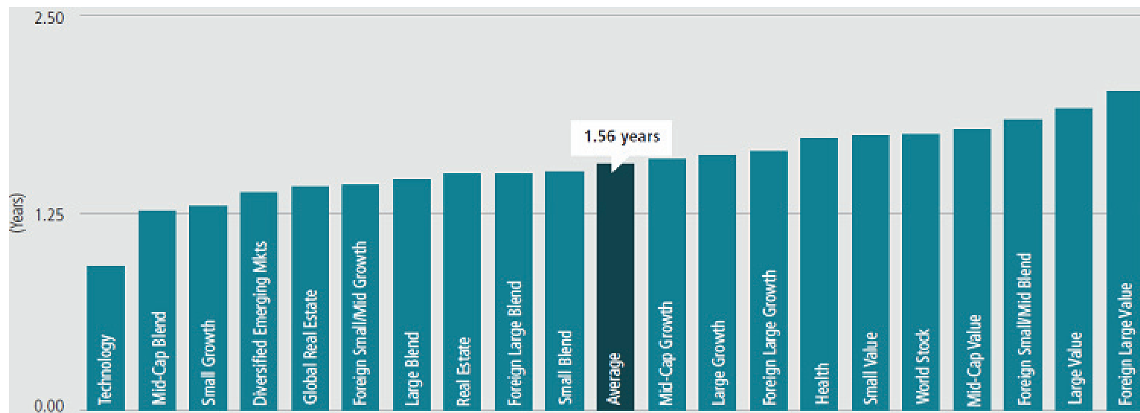
One might expect that professional investment managers would have a more long-term perspective. However, the data suggests that investment managers take an equally short-term view in their investment approach. Figure 2 depicts the average holding periods of investment managers of stocks in equity mutual funds. On average, investment managers turn over their companies every 1.56 years. This analysis uses the inversion of turnover as a simplified alternative to holding periods, which could differ based on the specific securities purchased or sold.

Figure 2: Reasons for short-term orientation
Stock holding periods by investment managers for 20 largest Morningstar equity categories (31 Dec 2015)




Sources: Morningstar Direct. Data reflects largest 20 US open-end equity mutual fund categories as at 31 December 2015. Holding periods were calculated by taking 1 over the most recent average annual turnover ratio for each category.

A number of reasons have been posited for the short-term investor behaviour observed. These include incentives, media and financial reporting and decision-making biases.

## INCENTIVES

It is a truism that individuals respond to incentives. In recent decades, changes in incentives have included the significant revamping of executive compensation, firms increasingly outsourcing investment decisions to external advisors such as consultants as well as outsourcing the CIO function (O-CIO), and many investment firms changing their ownership structure from being private partnerships to being subsidiaries within large financial conglomerates.

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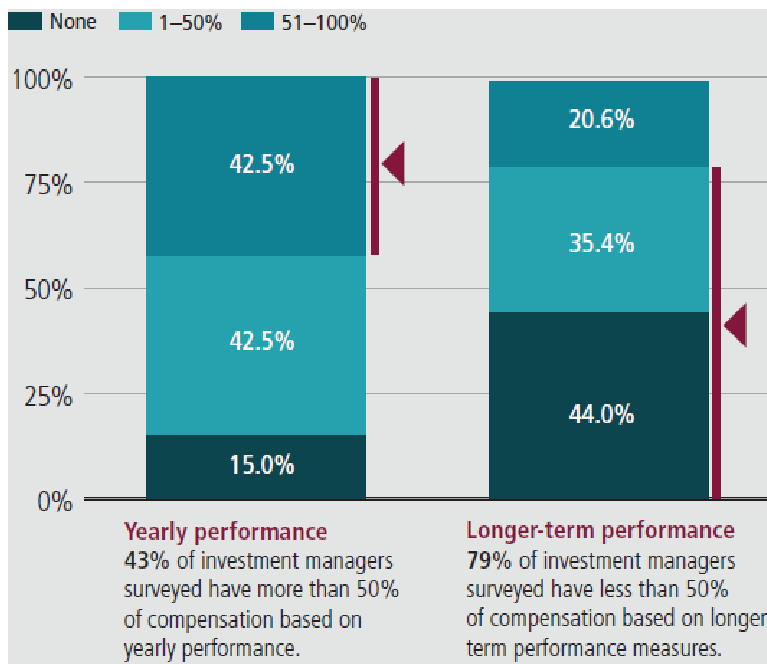
While many asset owners have longer time horizons, the investment management industry remains focused on compensation incentives geared to the short term. Figure 3 below shows the results of a compensation study of more than 1,100 investment management professionals conducted by the CFA Institute. As the exhibit reveals, a significant proportion of investment management professionals (43%) receive more than half of their compensation based on their annual performance – similarly, nearly 80% of investment management professionals surveyed have less than half of their compensation based on longer-term performance measures.

Figure 3: Short-term incentives for investment managers
What percentage of your compensation is related to the following?
(May 2008)




Sources: CFA Institute Short-Termism Survey, May 2008 (over 1,100 portfolio managers and analysts surveyed).

Consider for example, a portfolio manager compensated based on annual investment performance relative to a benchmark. In this case, compensation in the current year is completely independent of compensation in the prior or subsequent years. How long is the portfolio manager's time horizon at the end of October, when investment performance is lagging the benchmark, one might ask? Unsurprisingly, it is eight weeks.

The incentive structure in place encourages the manager to take excessive risk to optimise his or her compensation in the current period. The risks taken may not be appropriate for the portfolio and are also likely not reflective of the fact that most clients have a time

horizon that is longer than eight weeks. Furthermore, investment performance in this eight-week time frame is more likely driven by market noise than relevant investment signals.

## MEDIA AND FINANCIAL REPORTING

The media, analysts and various pundits churn out a vast amount of information and commentary on the markets. While investors need information from various sources to make decisions, it is important to make a distinction between general market noise and relevant investment signals. Nassim Taleb highlighted the way in which the media is paid to generate noise when he said, "People do not realise that the media is paid to get your attention. For a journalist, silence rarely surpasses any word."[1] In short, the media thrives on market noise, and in their world, the more chatter the better. It is the professionals' responsibility to distinguish the signals from the noise.

The emphasis on quarterly earnings is another example of the short-term focus of the investment community. While there is an abundance of short-term earnings estimates, there is a dearth of longer-term estimates - that is, those that are three-plus years out.

Figure 4 below shows the disparity between the 2017 and 2019 earnings estimates for two of the largest companies in the technology and financial services sectors. The focus on earnings estimates underscores the fascination of the market with trying to forecast quarterly earnings. It is also worth noting that sell-side firms that provide earnings estimates typically stand to gain from the additional revenue generated from more frequent trading activity. The lack of sell-side research that extends beyond the near term, along with the additional uncertainty implicit in taking a longer-term view, suggests that there is a role for independent research focused on adding value over longer time horizons. Additionally, the market trend of reduced trading commissions places additional pressure on brokerage firms to increase trading volume.

Figure 4: Research coverage has short-term focus
Earnings-per-share estimates for two global large-cap companies January 2016

| | Financial services | Technology |
|---|---|---|
| **2017** *Well covered* | Number of earnings estimates: **21**<br>Range: £0.44 – £0.69 | Number of earnings estimates: **47**<br>Range: $7.28 – $12.26 |
| **2019** *Minimal coverage* | Number of earnings estimates: **0** | Number of earnings estimates: **0** |

Sources: Factset

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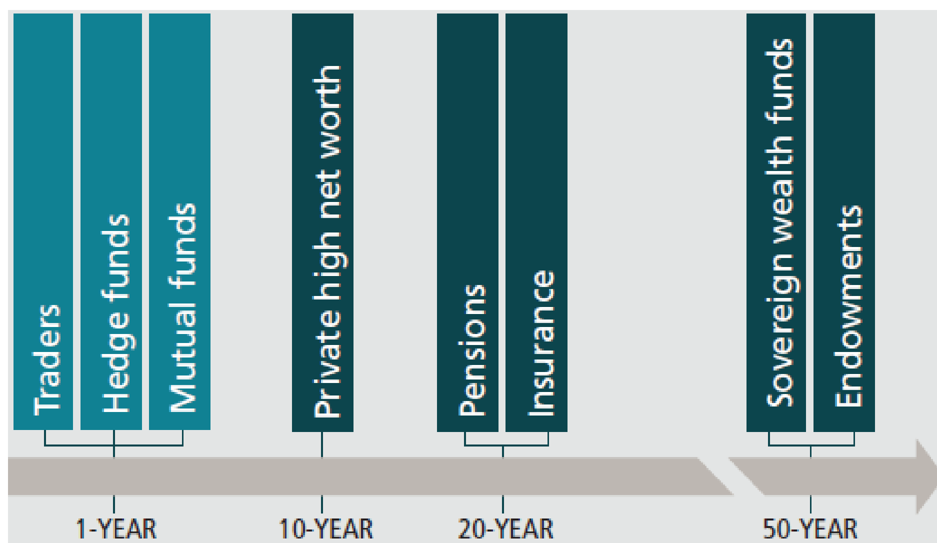
DECISION-MAKING BIASES

The field of behavioural finance has shone a spotlight on the psychological reasons why individuals fall prey to certain decision-making pitfalls, including short-term behaviour that prejudices long-term investment performance. These include: loss aversion, which refers to one's tendency to strongly prefer avoiding losses to acquiring gains; the availability bias that occurs when one makes judgments about the probability of events based on how easy it is to think of examples (the availability heuristic operates on the notion that if something can be recalled, it must be important); and, the recency bias, or party effect, which operates when stock market participants evaluate their portfolio performance based on their perspective on recent results. These biases, along with others, result in less than optimal results for the investor in the longer-term.

MISALIGNMENT OF ASSET OWNER AND INVESTOR GOALS

When examining the investment time horizon of clients - ranging from high-net worth private clients to pension funds, insurance companies, endowments and sovereign wealth funds - we find that the clients typically have time horizons of a decade or more, and, in many instances, have an explicit multigenerational objective (see Figure 5). For example, endowments, foundations, sovereign wealth funds and many private high net-worth clients fall into a group that invests for both current and future generations. This suggests that it would be rational for these investors, in particular, to adopt a longer-term perspective in their investment practices. The increased short-term focus of investors indicates a misalignment with those asset owners with a long-term time horizon.

Figure 5: Aligning with client's longer time horizons



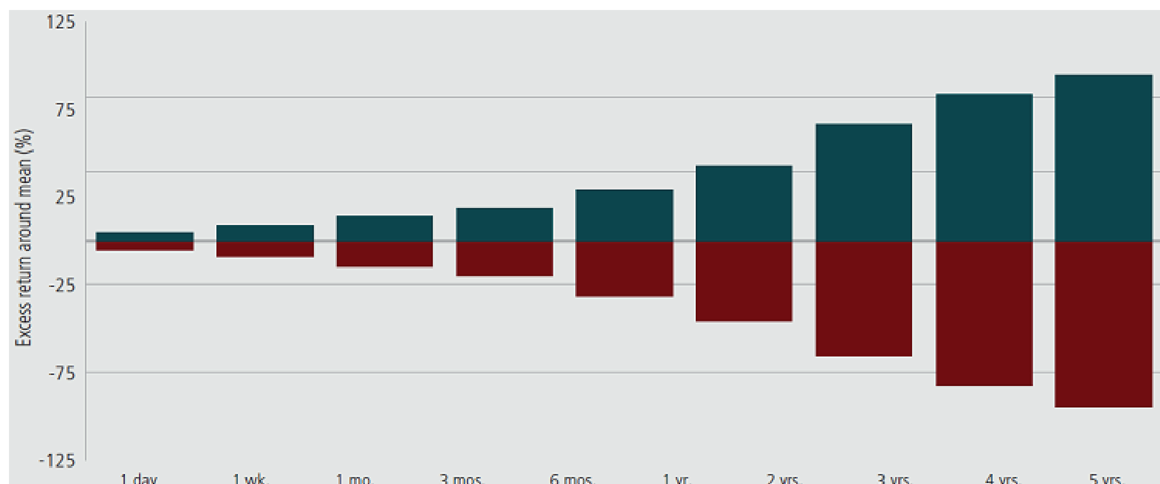

Sources: Based on 'Making Better Investment Decisions', Morningstar, 2012.

Furthermore, demographic trends point to even longer time horizons. The demographic shifts taking place in the world at large – both the continued rise in life expectancy and the fall in fertility rates – are a global megatrend with important implications for investment behaviour. The fall in fertility rates in both the developed and developing world means that a shrinking working-age populace will be called upon to finance the rising retirement costs of an aging population, further exacerbating the societal impact of longevity risk. The Bank for International Settlements (BIS), regards longevity risk – the risk of needing to make pension and annuity payments for longer than anticipated – as "significant when measured from a financial perspective".[2] No doubt, individual and institutional investors alike will increasingly need to take longevity risk into account, in concert with investment risk, when thinking about various types of investment products and strategies. This may in turn drive more long-term investment behaviour over time.

## ARBITRAGE OPPORTUNITIES WITH A LONGER INVESTMENT HORIZON

Investment managers with a longer-term view and a focus on stock selection can find abundant investment opportunities. This point is illustrated in Figure 6, which shows the return dispersion for stocks held for various time periods ranging from one day to five years. There is greater return dispersion between the tenth and ninetieth percentiles as the holding period extends, bolstering the view that there are more opportunities for differentiated performance when one holds securities for three to five years.

Figure 6: Return dispersion grows with time
MSCI World total return dispersion around the mean return
(2011–2015)




Sources: MFS research. MSCI World holdings as at 1 January 2011. Forward total cumulative returns around the mean in USD within the 10th to 90th percentile range.

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How does this impact investment strategy? It is difficult for a portfolio manager to profitably trade markets on a weekly basis because stocks tend to move in tandem in the short term and the opportunity to add value after trading costs is very limited. However, five years out, there is much greater return dispersion in the market, which creates the potential for investment managers to post strongly differentiated performance relative to the benchmark. This time horizon arbitrage opportunity can be a significant factor in generating long-term performance. Over a longer time period, there is an opportunity for investors to focus on meaningful investment signals that point to sustainable earnings growth in the medium-to-long term and express differentiated views that translate into positive performance.

## CONCLUSION

Keynes famously used the analogy of a beauty contest to explain why stock prices can differ from their fundamental value. He describes the actions of rational agents in a market using an analogy based on a fictional newspaper contest, in which entrants are asked to choose the six prettiest women from a hundred photographs. Those who picked the most popular face are then eligible for a prize. A naive strategy would be to choose the face that, in the opinion of the entrant, is the most beautiful. A more sophisticated contest entrant, wishing to maximise the chances of winning a prize, would think about what the majority perception of beauty is, and then make a prediction based on some knowledge of the public's perceptions.[3]

Keynes believed that similar behaviour was at work in the stock market – that is, that investors often ignore underlying conditions and, instead, try to extrapolate short-term market psychology as a way to derive investment returns. It is likely Keynes would see this mindset reflected in current investment behaviour where the focus is often on short-term trading activity in reaction to market noise – that is, what other market participants are thinking, rather than investment decisions based on the fundamental longer-term value of an enterprise.

With demographic trends pointing to a greater focus on longevity risk and more attention being placed on the downside of short-term investment behaviour by governments, regulators and even the financial media, the tide may turn in the coming years. Regardless, an arbitrage opportunity exists for managers with a longer investment horizon: There are more opportunities for differentiated performance when one holds securities for longer time periods.

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## ENDNOTES

1. Nassim Nicholas Taleb, Fooled by Randomness: The Hidden Role of Chance in Life and in the Markets, 2nd ed., (New York: Thompson Texere, 2004), 61.

2. BIS website (10/15/2013) https://www.bis.org/publ/joint31.htm

3. John Maynard Keynes, The General Theory of Employment, Interest and Money (1936), Chapter 12.

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