

Lengthening the Investment Time Horizon

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In Brief

- Investors are increasingly short term in their orientation, reacting to market noise, rather than basing investment decisions on the fundamental longer-term value of an enterprise.
- Incentives, media, financial reporting and numerous decision-making biases may be the cause of this short-term orientation.
- An arbitrage opportunity exists for managers: A longer holding period may offer more opportunities for differentiated performance.

The short-term nature of a large portion of investment behavior today is clearly revealed when looking at market data. Stocks are being held for record-short periods of time, and professional asset managers generally take a short-term view as well.

Wall Street's research coverage over emphasizes recent data points and under emphasizes what is material. Near-term corporate earnings take center stage rather than medium-term cash flows and what drives them. Moreover, markets have a tendency to overreact to short-term events, whether or not material, which can create market inefficiencies.

We believe that there is a time horizon arbitrage opportunity in the marketplace, which managers with a disciplined investment process can capitalize 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.

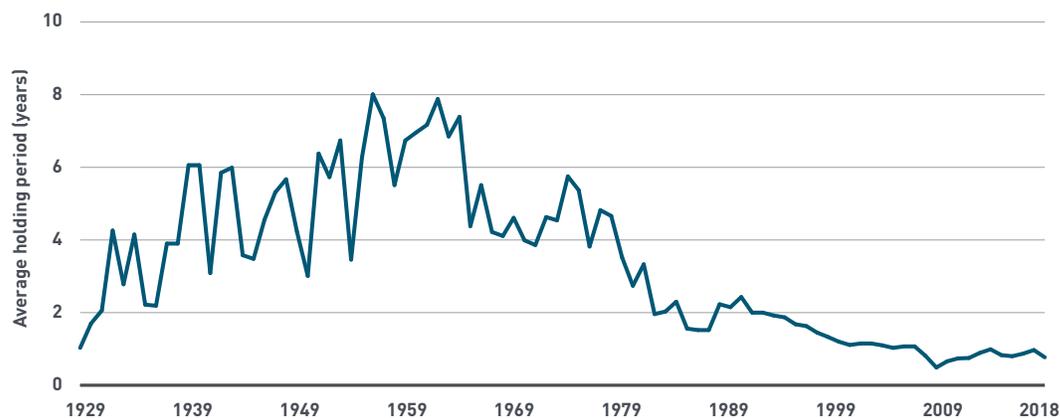
"A long term investment horizon is a responsibility and an advantage."
— CalPERS 10 Investment Beliefs, September 2013.

Shrinking time horizon

Stocks are being held for shorter periods than at any time since the 1920s. The New York Stock Exchange (NYSE) average holding period for a stock is approximately nine months (Exhibit 1). 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. It should be noted that these professionals manage significant mutual fund asset pools that are driven by retail investors.

Exhibit 1: Short holding periods: Lack of conviction?

NYSE average holding periods, 1929 – 2018



Sources: Barron's, IDC, as of 12/31/18.

One might expect that professional investment managers would have a more long-term perspective. It appears, however, that many investment managers take an equally short-term view investment approach. This short-term behavior may be driven by several reasons, including 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 (OCIO), and many investment firms changing their ownership structure from private partnerships to subsidiaries within large financial conglomerates.

Despite many asset owners have longer time horizons, compensation for the investment management industry remains focused on short-term incentives. For example, consider a portfolio manager that is compensated based on annual investment performance relative to a benchmark. Compensation in the current year is completely independent of prior or subsequent years' compensation.

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.

This incentive structure encourages the manager to take excessive risk in order to optimize his or her compensation in the current period. The risks taken may not be appropriate for the portfolio and may not reflect that most clients have a time horizon 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 distinguish between general market noise and relevant investment signals. The media thrives on market noise — the more chatter, the better. It is the professionals' responsibility to distinguish the signals from the noise.

The quarterly earnings cycle 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, *i.e.*, those that are out three years or longer. Exhibit 2 shows the disparity between the 2019 and 2024 earnings estimates for two of the largest companies in the technology and financial services sectors. Paralleling the research focus, the market is extremely efficient near-term, but is far less efficient three to five years out. Having a long-term differentiated view can create opportunity.

Also of note, sell-side firms that provide earnings estimates typically benefit from the additional revenue generated from more frequent trading activity. The lack of mid- to long-term sellside research, along with the additional uncertainty implicit in 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.

Exhibit 2: Short-term focus creates opportunity for investors with differentiated long-term view

Earnings-per-share estimates for two global large-cap companies as of September 2019

| Financial Services | | |
|--------------------|----------|-------------|
| | Analysts | Range (GBP) |
| 2019 | 21 | 0.534–0.626 |
| 2023 | 0 | |
| 2024 | 0 | |
| Technology | | |
| | Analysts | Range (USD) |
| 2019 | 43 | 11.40–11.80 |
| 2023 | 0 | |
| 2024 | 0 | |

Source: Factset.

Decision-making biases

The field of behavioral finance highlights why individuals fall prey to certain decision-making pitfalls, including short-term behavior that prejudices long-term investment performance. These include:

- **Loss aversion:** Preferring strongly to avoid losses over acquiring gains
- **Availability bias:** Making 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)
- **Recency bias (party effect):** Evaluating portfolio performance based on a perspective of recent results

These biases, along with others, result in less than optimal results for the investor in the longer-term.

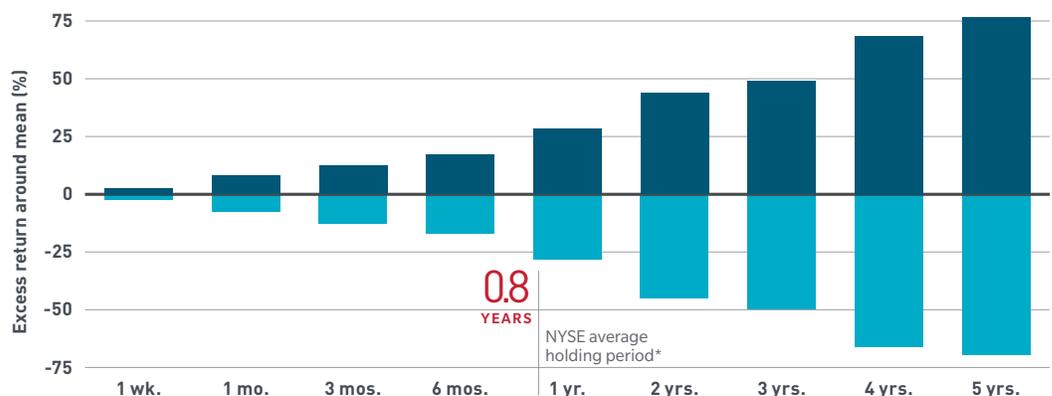
The increased short-term focus of investors indicates a misalignment with those asset owners with a long-term time horizon.

Misalignment of asset owner and investor goals

Our clients — ranging from high-net worth private clients to pension funds, insurance companies, endowments and sovereign wealth funds — typically have time horizons of a decade or more. Moreover, endowments, foundations, sovereign wealth funds and many private high net- worth clients often invest for both current and future generations. It could 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.

Exhibit 3: Greater dispersion over time offers opportunity

MSCI World Index total return dispersion around the mean return 2014-2018



Source: MSCI. The MSCI World Index measures stock markets in the developed world. MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities or financial products. This report is not approved, reviewed or produced by MSCI.

*Source: Ned Davis Research Group, from Barron's and IDC. The average holding period for a stock was 0.8 years as of 12/31/18.

Arbitrage opportunities with a longer investment horizon

From our standpoint, investment managers with a longer-term view and a focus on stock selection can find abundant investment opportunities. This point is illustrated in Exhibit 3, 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.

How does this impact investment strategy? Stocks move in tandem in the short term, making it difficult for a portfolio manager to profitably trade on a weekly basis, and because of trading costs, the opportunity to add value is very limited. However, five years out, greater return dispersion creates the potential for investment managers to outperform relative to the benchmark. We consider this time horizon arbitrage opportunity to be a significant factor in generating long-term performance. We believe, over a longer time period, investors can focus on meaningful investment signals that point to sustainable cash flows in the medium- to long-term and express differentiated views that may potentially translate into positive performance.

Conclusion

Investors often ignore underlying conditions, and instead try to extrapolate short-term market psychology as a way to derive investment returns. This behavior is often focused on short-term trading activity in reaction to market noise, rather than investment decisions based on the fundamental longer-term value of an enterprise. With more attention being placed on the downside of short-term investment behavior by governments, regulators and even the financial media, the tide may turn in the coming years. Regardless, we believe 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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