This article is one of a series that looks at various aspects of long-term or, more precisely, “long horizon” investing. In this paper, we consider the nature of long-horizon investing, what success looks like and how such managers might be monitored on an ongoing basis.
LONG-HORIZON INVESTING — CAN IT BE DONE?

The nature of institutional investors is generally very long term because the obligations they aim to meet are due many years or decades hence, whether the investor is a pension fund, endowment or insurance business. Such institutions are natural investors in equities, expecting to benefit from relatively high returns driven by long-term corporate profit and dividend growth. An approach focused on capturing this profit and growth by making investments with low turnover — in relatively stable portfolios of underlying companies held over long periods of time — could be described as long-horizon investing.

In practice, equity manager turnover shows portfolios aren’t very stable and underlying companies are generally held for short periods (often less than two years). Of course, such averages can be misleading. In this case, the averages likely disguise what can be thought of as two styles of equity investing — managers who identify share prices they think will go up (by more than the market) and managers who identify companies they believe will grow (by more than the market expects) over the long term.

For many institutional investors, the second approach (which might crudely be considered investing rather than speculation) is more naturally aligned with their own long-term investment horizon. Critically, it is also consistent with their underlying raison d’être — to “grow” the savings pool sustainably by investing in equities in the first place. There are therefore two questions to consider:

1. Do such long-horizon managers really exist (and can they be readily identified)?

2. How should they be monitored (since short-term performance against market indices is likely to be a crude and potentially misleading measure of success)?

1. Increasingly, many institutional investors are constrained in their ability to take risk by solvency or regulatory considerations. Even Sovereign Wealth Funds (SWFs), perhaps the “ultimate” long-horizon investors, are constrained by political pressures. This may constrain the quantum of equity in their portfolios, but this equity allocation is typically held for a very long period.
The true long-horizon investor will agree that the company is held for its long-term growth not its shorter-term share price performance; great companies are so “thin on the ground” that an investor would need to think carefully about disposing of one in favor of other opportunities.

The answer to the first question is undoubtedly yes. Managers who focus on buying companies for the long term do exist, though they’re rarer than one might expect. Warren Buffet’s approach of buying wonderful businesses at fair prices and holding them forever is relevant here. But this brings up additional questions:

1. Do such great businesses exist? Probably yes.

2. Are they sufficiently stable and enduring that “holding them forever” (that is, for ten years or more) is a viable strategy? Again, the answer is probably yes, although with less certainty than the answer to Question 1. Through changing external or internal circumstances, great companies may not persist for an extended period of time (because the product they sell becomes obsolete, for example, or because management embarks on a diversification spree).

3. Is holding them forever regardless of price a realistic strategy? Even the greatest company (or any asset) can become overvalued relative to its realistic future growth prospects. Should the manager ignore this overpricing and continue to hold the asset even though it’s likely to underperform over an extended period as the overpricing corrects? Or would it be more prudent and more pragmatic to take some profits and invest in other great companies that aren’t equally overvalued?

The true long-horizon investor will probably agree that a) the company is held for its long-term growth not its shorter-term share price performance, and b) great companies are so “thin on the ground” that an investor would need to think carefully about disposing of one in favor of other opportunities. The risk may be that it proves impossible to buy the company back at a reasonable price (because it remains overvalued or becomes even more so).
TWO CATEGORIES OF LONG-HORISON INVESTOR

In fact, there are arguably two distinct styles of long-term equity investing.

A majority of managers in this category would focus on high-quality companies with strong brands, large market shares, high barriers to entry, low operational gearing, robust balance sheets, etc. Such companies would have the ability to earn higher rates of return on capital employed ad infinitum (or at least over many years). This investment strategy tends to be successful because the majority of other investors assume the returns earned by these companies will eventually return to the average rate, whereas the long-term investor is confident these businesses will “beat the fade.” In practice, the maintenance of high levels of return — arguably a function of the quality of the business — allows long-term compounding of attractive levels of return, generally outperforming companies with less enduring or more volatile returns.

The second type of long-horizon investor is almost completely different. This type of manager buys companies he or she expects to grow to a much greater extent than the market currently believes. The companies will already have been identified as high growth by the market, but such managers believe the market lacks the imagination or time horizon to understand how fast and for how long the business can actually grow.

What the two approaches have in common is a much longer time horizon than the market generally. The success of these approaches won’t be appropriately assessed by considering the movement of share prices over short- or even medium-term periods, whether in absolute or benchmark-relative terms. The success of the former group will only be genuinely visible if the portfolio of companies selected to compound returns at medium-to-high rates on a consistent basis over a long period of time succeeds in delivering this objective. What happens to share prices in the interim is arguably just noise.
The success of the second group won’t be about consistency and compounding (it may well be a much bumpier ride) but about the company’s total growth being far in excess of what the market expected at outset. Again, share price movements along the way (which could be highly volatile) are really just so much noise.

A word about value investing: You’ll note nothing has been said about value investing as an inherently long-term approach. Value investors generally buy assets they believe to be wrongly priced by the market and wait for the market to come to its senses or for some catalyst to realize the value they’ve identified. Although this is undoubtedly a patient form of investing, it isn’t necessarily long term in nature: If the catalyst happened the day after the shares were bought, the value investor would cheerfully sell. The changes he or she is waiting for often take a long time to happen but can take place in the short term. The long-term investors we’re focusing on can only see the fruits of their investment approach delivered over the longer term.

**KNOWING WHAT SUCCESS LOOKS LIKE**

We’ve established that there are two long-horizon styles of equity investment that may have the capacity for success because they exploit the market’s inability to focus on gains available in the more distant future. The nature of this long-horizon style of investing, focused on the long-term growth of underlying businesses, may not be mirrored by share price performance over shorter periods. Therefore, measuring performance by comparing share price movements with the market average over short periods of time is likely to be fruitless at best or misleading at worst. But we do need to find a way of measuring how the portfolio of shares is progressing — is it on track or has it gone off the rails?

For the first group, compounding, this probably isn’t too difficult. It should be possible to look at the whole portfolio and measure it as if it were a single company. For example, looking at whether dividends have increased, return on capital has grown and whether the balance sheet has remained strong. This would mean the deliberate use of a combination of measures that are naturally in tension and therefore cannot be easily manipulated either by the
asset manager or the managers of the companies in the portfolio. An increase in dividends with an increase in gearing would be an undesirable combination, for example.

At the outset of such a mandate, the asset owner and the asset manager would agree on measures to be reported on a regular basis and how these would be expected to evolve over time. Ultimately, both will assume that if the companies develop as expected, the reward will be attractive total returns — over time periods of perhaps five years or more. Measuring progress along the way will align the views of investor and manager. It will also enrich initial discussion about what the manager is trying to achieve and how, ensuring the performance measurement discussion rises above the short-term “are you ahead or behind the index?” question.

For the second type of manager, who invests in what might be called “transformational growth” companies, the same measurement approach won’t work. Companies growing at very rapid rates are unlikely to see dividends at all or neatly corresponding returns on capital. For these companies, more of a private equity approach is likely to be required. When the manager acquires shares in the company, what are the expectations for growth (sales might be a more likely measure than earnings), and how do these compare with the company’s business plan? The manager should be prepared to report on whether the companies in the portfolio are in line with, ahead of or behind growth expectations and, more importantly, why. This will enable the investor to monitor progress of the portfolio over time and understand how the underlying companies are increasing in value (almost regardless of the market price). As above, the establishment of a monitoring process that works for both investor and manager should enrich the debate at the outset of the mandate and ensure ongoing monitoring discussions are relevant and effective.
CONCLUSION

Long-horizon investors can be characterized as participating in the long-term growth of businesses rather than short-term movement in share prices. They expect the growth of those businesses over the long term to be rewarded by attractive total returns to the investor. Monitoring share prices and portfolio performance against market averages is a poor way of assessing progress over short periods because of the prevalence of “noise” in these share price movements. There is also the risk that by focusing on this measurement, managers might make decisions that have short-term justification but are value-destroying in the longer term. This approach should also lead to investment managers having higher-quality conversations with corporate management and ultimately help break the short-termist cycle.

A better approach is for the investor genuinely to understand—and, by implication, buy into—the manager’s approach, agreeing at outset on the measures for monitoring the progress of the portfolio on a regular (but not too frequent) basis. This should more closely align investors and managers and make for a much better-informed discussion about portfolio performance, ultimately leading to good long-term relationships and better long-term returns.
NEXT STEPS

Mercer intends to develop this thinking by gathering a group of like-minded asset managers to determine how long-horizon approaches can be identified and monitored. The next stage will be to open the discussion to select asset owners to see if they genuinely have an appetite to move away from benchmark-relative performance measurement and what the benefits might be.
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