

Short-termism

A real or imaginary problem?

In short

We consider whether short-termism is a real or imaginary problem. We note that many great minds have debated this issue and therefore abstain from presenting a view on the ‘big picture’. Instead we restrict ourselves to considering the smaller world of pension fund governance. Here, we believe there are opportunities to profit from a longer-term view, albeit that it is challenging.

Is short-termism a problem?

There has been a recent marked upwelling of interest in ‘long-term investment’ within the pension fund industry – whether in growing discontent with benchmarks and tight tracking errors, or the financial stability of the asset management industry, or in the launch of competitions to find original long-term investment solutions. The implication is that short-termism is a problem, and must be defeated. But is this a real problem, or is it merely imagined?

Philosophical stuff

We need to ask ourselves a simple but (genuinely!) profound question; is the ‘long-term’ different to a succession of ‘short-terms’? While this may appear a stupid question, we will need to be able to answer “yes” if we wish to go on to defeat short-termism. More importantly, we will need to be able to demonstrate *why* the long-term is different to a succession of short-terms. Consider an example: if the stock market were to close tomorrow and not reopen for three years, would you hold a different portfolio to the one you currently own? If so, why?

A brief history of angst

The issue of the short-term versus long-term has fuelled a long-running debate (occasionally heated) in the world of economics, politics, business and investment. We present the briefest of reviews:

Keynes – 1936¹

Stock market investment is not a long-term activity

Wilson – 1965-9²

The first government to attempt to tackle the perceived problem

Marsh – 1990³

The problem is imagined rather than real

Hutton – 1995⁴

Short-termism is a problem, the desire for liquidity the cause, and state intervention the solution

Myners – 1999⁵

Quarterly trustees’ meeting cycle promotes short-term behaviours

A mathematical aside

Mathematics has an interesting light to shed on the debate by identifying the (very special) conditions under which it is appropriate for a long-term investor to behave as a short-term one⁶. As these conditions are not met in the real world we conclude, from a mathematical perspective, that a long-term investor should not make the same decisions as a short-term investor. So why might a pension fund end up investing short-term?

Human behaviour

The field of behavioural finance is being seen as having something to offer as far as understanding investor behaviour is concerned. Here we consider some issues arising from human behaviour which we believe, in general, adversely affect the returns of pension funds.

Measuring things

The dictum, what gets measured gets managed, can surely be extended to ‘short-term measurement leads to short-term management’. However, high frequency measurement carries a high emotional cost (see *The pain of loss*), and in addition it is almost impossible to distinguish between skill and noise. The classic example here is managers’ track records (noise) having almost nothing to say about future performance (skill). So why do we think more information is better information? Looking at returns for two quarters rather than one six-month period gives twice as much data, but no more information. And why do we

feel more in control with more frequent information? We would argue that the information has limited value – interpretation is everything.

In seeking to invest long-term we are implicitly seeking to make infrequent changes, and from experience this is incompatible with frequent measurement. To enhance returns therefore we must be willing to forgo the semblance of control that goes with frequent measurement, and adopt a more appropriate timescale⁷.

The pain of loss

While it is obvious that nobody likes losing, behavioural finance has shown that we place twice as much significance on a loss as we do on a gain of the same magnitude⁸. From observation we would assert that the prospect of the pain of large losses tends to cause comfort-seeking behaviour by institutional investors (whether the herding of asset allocations, or funds replacing managers).

The pain of being contrarian

We would further assert that the above comfort-seeking behaviour carries a real cost – a comfort premium, which is paid to contrarian investors⁹. So there appears to be a return opportunity in adopting a contrarian approach, albeit with the difficulties that Keynes outlined in 1936. The primary difficulty, of course, is acting long-term. Judging a contrarian investor through the TMT bubble would have required a timeframe of several years rather than several quarters, as the momentum persisted for so long.

Overconfidence

We humans tend to have higher opinions of our ability in the low-signal, high-noise investment world than is objectively warranted. For example, consider new information entering the system. An individual investor can, with good insight, execute a profitable trade. But we must assume good insight, because at the aggregate level there is no net trade – we are simply shuffling share



certificates and paying for the privilege of doing so. This situation is an example of the *fallacy of composition* which refers to any situation where action that is advantageous for an individual is disadvantageous if attempted by all individuals. So why do we think we will be the winning, rather than losing, investor? In a similar manner to the contrarian approach advocated above, return opportunities will be available to those investors with a clear understanding of any comparative advantage they have, and hence are able to exploit. The chart opposite shows the explosive growth in UK equity turnover. This has enriched the broking community and impoverished the *average* pension fund.

Game theory

One of the peculiar issues of institutional investment is the proliferation of agents involved in investing the assets on behalf of the owners. The field of game theory within economics deals with the interaction of individuals, each of whom is driven by self-interest. As short-termism is driven by the behaviours of individuals, which in turn are driven by incentives, we need to learn about how to create incentives that engender long-term behaviour – and hope that we are smart enough to escape the law of unintended consequences.



1. *The General Theory of Employment Interest and Money* (1936), ch 12
2. Some have argued that, ironically, the actions exacerbated the problems of short-termism in the UK. See for example, *Corporate Governance in a Political Climate: 'New' Initiatives by 'Old' Labour in the UK, 1965-69* by Bowden and Gamble, University of Sheffield May 2000
3. *Short-Termism on Trial*, Paul Marsh 1990, sponsored by the Institutional Fund Managers Association
4. first published 1995, Random House
5. Institutional Investment in the United Kingdom: A Review, March 2001
6. The main condition being that returns are 'independently and identically distributed'. See *Strategic Asset Allocation*, 2002 OUP, by John Campbell and Luis Viceira
7. see *Time to stop looking*, Watson Wyatt, 15 July 2000
8. see for example, Amos Tversky's *Behavioural Finance and Decision Theory in Investment Management*, AIMR publication 4 April 1995
9. see for example the sources quoted in the Background section of *Time to stop looking*, Watson Wyatt publication 15 July 2000

In conclusion

We believe short-termism is a real problem for the following reasons:

- returns are reduced by too much trading cost,
- paying away a comfort premium to avoid looking wrong in the short term costs, and
- it leads to a lack of governance, which must be a long-term activity, thereby reducing the aggregate efficiency of the economy.

Solutions will be harder to identify – we will need to grapple with our own behaviour, understand our incentives, and revisit the way we make decisions. In particular, we are advocating 'Ten-year Mandates' with real return targets. Difficult, but the rewards would appear worth it.