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INSIDE

guestperspective

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By James Montier

ADHD...

Time Horizons & Underperformance

ADHD seems to plague financial markets at all levels. Performance is measured on increasingly short time horizons. Such myopia is often self-fulfilling, the more an investment is checked the more likely you are to find a loss. Even in an artificial universe of skilled investors we found runs of 3 years of back-to-back underperformance were commonplace. We need to extend our time horizons.

• Attention deficit hyperactivity disorder (ADHD) seems to be pervasive in our industry. Trustees, consultants and internal managers seem to want to evaluate fund managers as frequently as possible. Indeed recent evidence suggests that the average holding period of mutual fund investors has fallen from over 10 years in the 1950s to around 4 years currently.

• Short time horizon performance measurement leads to closet indexing. Fund managers are often rewarded with respect to assets under management. Hence they will try maximizing those assets. Retention is usually therefore the end objective. The easiest way of losing funds under management is to under perform. The easiest way of avoiding underperformance is to track your benchmark.

• Professional investors have seen their time horizons contract as well. The average holding period of a stock on the NYSE is just 11 months, compared to 8 years in the mid-1950s. Such short holding spans have nothing to do with investment, they are pure speculation. Corporate managers have also been caught up in this ADHD epidemic. Loaded up as they are with stock options, and hence they too seem willing to sacrifice long-term value for short-term gain. All of which has led to a situation where, as Keynes put it, "*Investment based on genuine long-term expectation is so difficult to-day as to be scarcely practicable*".

• To show how ridiculous this obsession with the short-term is, we created an artificial universe of 100 fund managers. Each had a true alpha of 3% and a tracking error of 6% (such performance would put them in the top quartile of investors). We then subjected them to random shocks. After 50 years, the 'best' fund manager had an alpha of 5%, the 'worst' 1%.

• In every year roughly one in three of our fund managers underperformed. Over a 50-year time span, such a skilled investor should expect to under perform in about 15 of them. Perhaps most revealing was the risk of back-to-back years of underperformance. Almost half our universe experienced a run of three years of back-to-back underperformance. Runs of four or five years were not uncommon! 70% of our make-believe managers suffered 3 or more years of underperformance. They would most likely have been fired many times over, despite their underlying true (by construction) value added.

? We need to extend time horizons. That means being honest with clients about the risk of underperformance, and admitting limited skill when it comes to picking investments for the short-term. Of course, this will come as an anathema to most investors.

ADHD, Time Horizons and Underperformance

Our industry seems bedeviled by myopic time horizons. Almost everywhere you look you seem to encounter an obsession with the short-term. Trustees, consultants and internal managers seem to want to evaluate fund mangers as frequently as possible. Not only do people want to measure performance on increasingly short time horizons, they also seem to wish to act more often as well. Indeed John Bogle1 (of Vanguard legend) has recently noted that the average holding period for mutual fund investors has fallen from over 10+ years in the 1950s to around

RESEARCH DISCLOSURES PAGE 5

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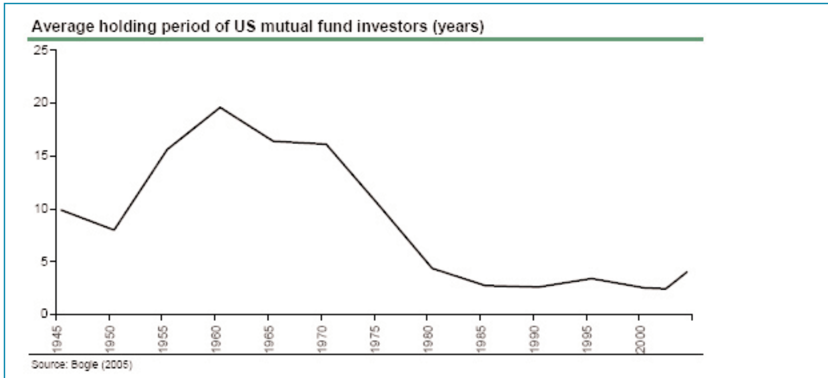


4 years currently.

These increasingly short time horizons used to evaluate fund mangers are likely to push them into closet index tracking behavior. In a world in which fund managers are motivated by being paid a fixed percentage of assets under management, they will, of course, aim to maximize assets under management rather than the returns from the assets. The easiest way of losing funds under management is to under perform. The easiest way of avoiding under performing is to track your benchmark and thus we arrive at closet indexing.

The contraction of the ultimate investors' time horizons has driven/coincided with a collapse in the time horizon of institutional fund managers. The chart overleaf shows the average holding period of stocks on the NYSE. In the mid-1950s, investors used to hold stocks for 7-8 years. The average holding period today is just 11 months! Nor is this decline merely the result of the rise of hedge funds. Bogle (op cit) presents findings on the average holding period of professional investors from an entirely different source. Yet his data maps closely to the general trends of the NYSE series we use (see the top chart overleaf).

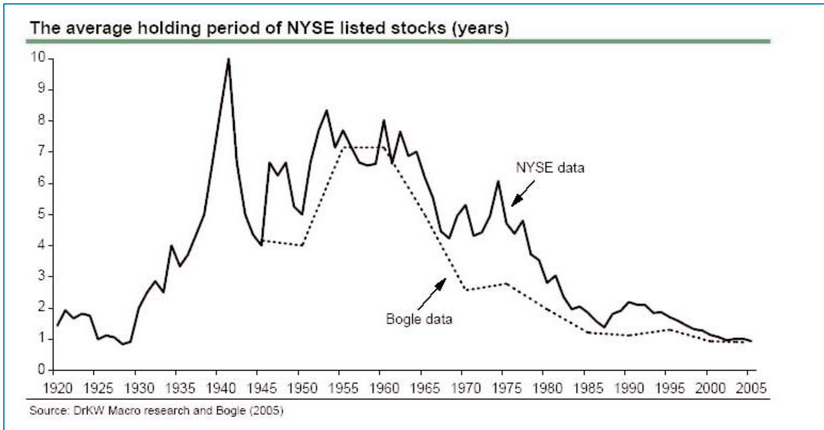
Of course, corporate managers feel the pressure too. They have become obsessed with short-term earnings announcements motivated by their overload of stock options. Indeed a recent survey from Campbell Harvey, John Graham and Shiva Rajgopal2 found that nearly half of the CFOs they interviewed would be willing to sacrifice a long-term valuable investment project if it meant missing earnings by $0.20!

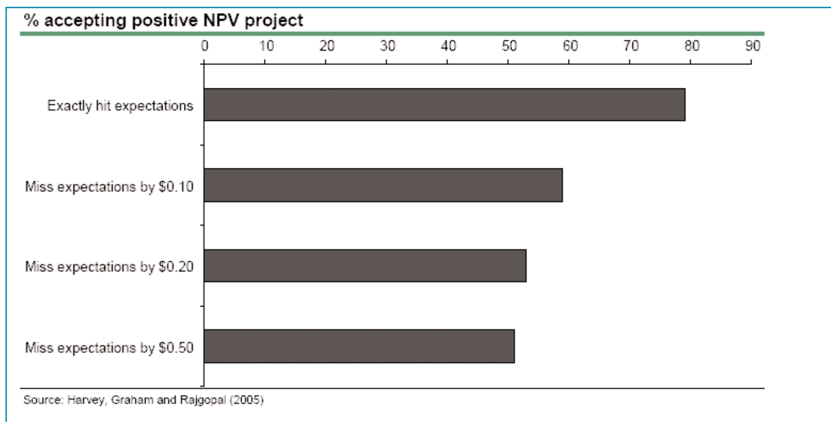
The chart on page 3 highlights the results they found. The question the CFOs were asked was "Your Company's cost of capital is 12%. Near the end of the quarter, a new opportunity arises that offers a 16% internal rate of return and the same risk as the firm. What is the probability that your company will pursue this project in each of the following scenarios: If you take the project you will (i) exactly hit consensus earnings, (ii) miss consensus by $0.10, (iii) miss consensus by $0.20 and (iv) miss consensus by $0.50".

The Harvey et al study also uncovered why so many CFOs aimed to meet expectations.
The two most popular reasons given were "to build credibility with the capital market" and "to maintain or increase our stock price". When asked why they preferred smooth earnings paths, the two top answers were "It is perceived as less risky by investors" and
"It makes it easier for analysts/investors to predict future earnings"!

All of which has lead to a situation where as Keynes put it.

> Investment based on genuine long-term expectation is so difficult today as to be scarcely practicable. He who attempts it must surely lead much more laborious days and run greater risks than he who tries to guess better than the crowd how the crowd will behave; and, given equal intelligence, he may make more disastrous mistakes... It needs more intelligence to defeat the forces of time and our ignorance of the future than to beat the gun. Moreover, life is not long enough; – human nature desires quick results, there is a peculiar zest in making money quickly, and remoter gains are discounted by the average man at a very high rate. The game of professional investment is intolerably boring and over-exacting to anyone who is entirely exempt from the gambling





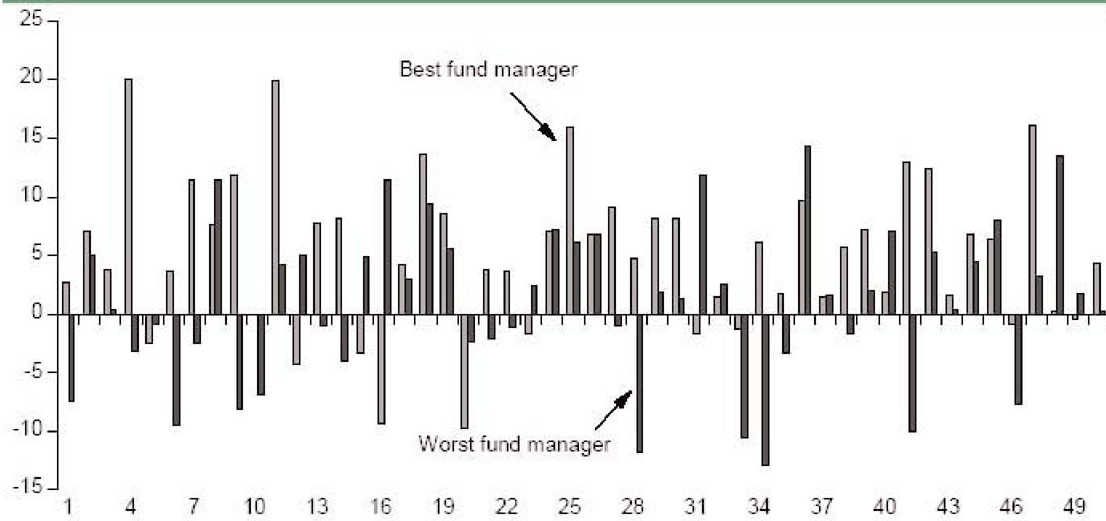
instinct; whilst he who has it must pay to this propensity the appropriate toll. Furthermore, an investor who proposes to ignore near-term market fluctuations needs greater resources for safety and must not operate on so large a scale, if at all, with borrowed money – a further reason for the higher return from the pastime to a given stock of intelligence and resources. Finally it is the long-term investor, he who most promotes the public interest, who will in practice come in for most criticism, wherever investment funds are managed by committees or boards or banks. For it is in the essence of his behavior that he should be eccentric, unconventional and rash in the eyes of average opinion. If he is successful, that will only confirm the general belief in his rashness; and if in the short run he is unsuccessful, which is very likely, he will not receive much mercy. Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally. (Chapter 12, General Theory of Employment, Interest and Money, 1936)

If we are ever to hope of actually meeting the aims of the ultimate investors we will need to rethink incentives and investment approaches. I will postpone the discussion of changing the incentive structure of our industry for another time. Here I want to concentrate on just how ridiculous the obsession with the short-term actually is. In order to illustrate the problem I decided to imagine a universe of 100 fund managers each with a 3% alpha and 6% tracking error or a population of 0.5 information ratio investors if you prefer. An information ratio of 0.5 is pretty good. According to Grinold and Kahn3 an information ratio of 0.5 would put these investors in or close to the top quartile.

US active equity information ratios

	Mutual Funds		Institutional Portfolios	
Percentile	Before Fees	After Fees	Before Fees	After Fees
90	1.33	1.08	1.25	1.01
75	0.78	0.58	0.63	0.48
50	0.32	0.12	-0.01	-0.15
25	-0.08	-0.33	-0.56	-0.72
10	-0.47	-0.72	-1.03	-1.25

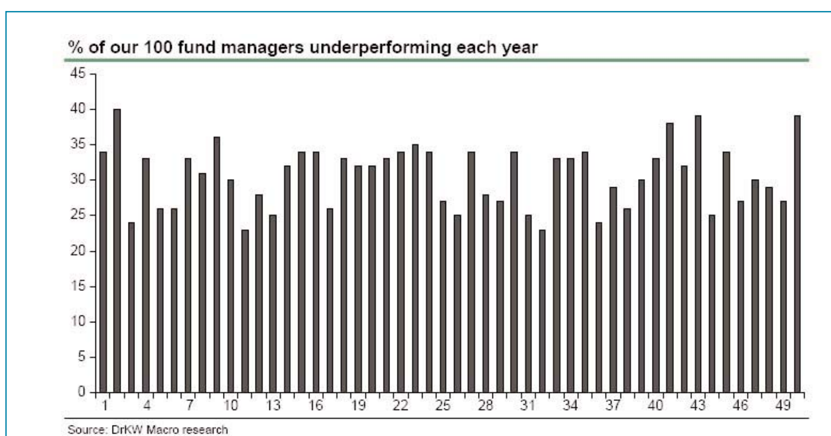
Source: Grinold and Kahn (2000)



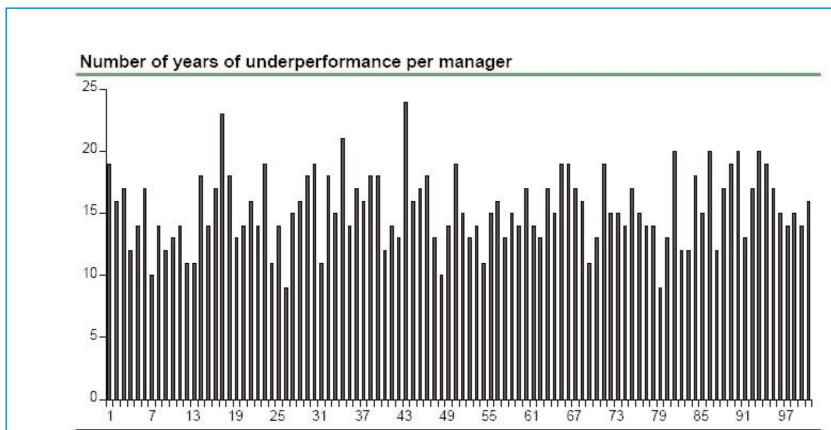
I set up this little universe of pretty good investors and then hit them with random shocks. Remember by set up each of these fund managers has a true alpha of 3%. In my little artificial universe I let these managers run money for 50 years and tracked their performance over time. The results were telling.

In terms of the range of returns the best fund manager displayed an alpha of 5.2%, whilst the worst showed an alpha of 1%. The top chart overleaf demonstrates just how hard it is to tell the 'good' from the 'bad' on the basis of annual returns. However, of more interest to me was the various statistics we collected on underperformance.

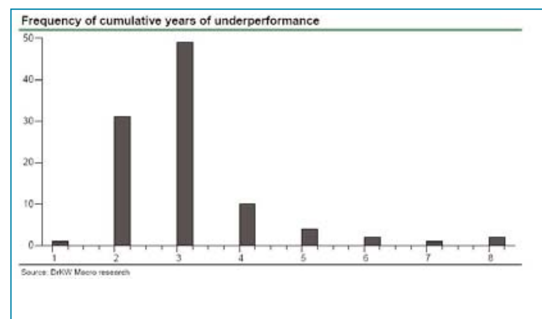
For instance, when looking at the cross section, pretty much one in three of our fund managers underperformed the benchmark each and every year.



An alternative perspective is given in the chart on the chart below. This shows the total number of years in which each of our fund managers encountered a negative return that is they underperformed their benchmark. On average, each of our managers spent about 15 years out of our 50-year sample underperforming, the minimum was 9 years, and the maximum was 24 years!



The chart below shows the histogram of consecutive years of underperformance. On average, even with an information ratio of 0.5, runs of three years of back-to-back underperformance were very normal. Indeed four or five years of continuous underperformance are far from unheard of.



Remember each of these managers has 3% alpha by design, yet that doesn't stop them encountering bouts of up to eight years of back-to-back underperformance. Despite the fund managers having a high alpha and a high information ratio, it wouldn't have been enough to prevent pretty much every one of the fund managers having been fired by their clients at some point over the fifty years of our data run.

Of course, when investors are myopic they tend to check their performance frequently. The more frequently they examine their portfolio performance the more likely they are to encounter a loss. Such myopic behavior almost becomes self-fulfilling.

We need to extend investors time horizons. That means being honest with the ultimate investors bout the risk of loss in the short-term (very high). It means encouraging longer holding periods and better-structured contracts between the ultimate investors and their chosen agents. It also requires dispelling the illusion of control and the illusion of knowledge such that fund managers admit to the truth that they can't pick stocks or markets over the short-run.

It also requires that investors try to stop 'beating the gun': instead of focusing on *speculation* (Keynes' term for the activity of forecasting the psychology of the market), we need to refocus our industry on *enterprise* (Keynes' term for the activity of forecasting the prospective yield of assets over their whole life). This in turn means analysts need to stop obsessing about the next quarterly set of results, and corporate managers can get back to running their business for the benefit of shareholders, rather than pampering to the investment equivalent of those suffering attention deficit hyperactivity disorder (ADHD).

Keynes too was exasperated by the obsession with short-term performance. He opined "*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." If only!

[1] See Bogle (2005) The Mutual Fund Industry 60 Years Later: For Better or Worse? Financial Analysts Journal, 2005

[2] The Economic Implications of Corporate Financial Reporting (2005) Graham, Harvey and Rajgopal

[3] Active Portfolio Management (2000) Grinold and Kahn

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