WORLDWIDE
ASSET MANAGEMENT

# The Next Decade belongs to the Long-Term Investor

WHITE PAPER

# The Next Decade belongs to the Long-Term Investor

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## Executive summary

- We live in a world dominated by social immediacy. Being online most of the time makes us impatient. As a society, we overvalue immediate rewards and forget the long-term perspective. This leads to a "sandbag" approach to generational challenges, where quick fixes are preferred over long-term viable solutions.

- This short termism is a problem as it undermines future economic growth as the lack of long-term investments leads to slower GDP, higher unemployment and lower investment returns.

- In equity markets, stock-picking driven by fundamental analysis accounts for only 10% of the overall market turnover and the average holding period has fallen over the past decades from a peak of 7.5 years to an average of 6 months. Looking at sell-side research analysts, they – guided by their perceived client needs – focus on periods measured in quarters rather than years with less focus and knowledge on the 5-10-year perspective.

- At a corporate level, the rise in short termism is reflected in a decline in the average tenure of a CEO. Several studies have shown that the average tenure of a CEO in major US companies has fallen from around 6-7 years a decade ago to approximately 5 years today. Management teams are under external pressure to perform in the short term, thereby prioritizing short-term capital returns, the company's share price and making quarterly earnings forecasts rather than important longer-term strategic goals. This eventually leads to lower long-term value creation.

- Analysis shows that the biggest factor associated with lower long-term value creation is overdistribution of capital. We encourage companies to return capital to shareholders and companies must pay high attention to their cost of capital, although not at the expense of future growth.

- History shows that over the longer term, there are very few companies that can sustain and create attractive returns. Studies by McKinsey show that companies with a truly long-term culture and strategic thinking outperformed other companies by 36% in terms of earnings over a 15-year period. Furthermore, from a societal perspective, if all companies demonstrated long-term thinking, they could create an additional 1 million jobs per annum in the US alone.

- Looking at time horizons from the perspective of asset owners, it is a paradox that the average length of liabilities of sovereign wealth funds is approx. 50 years, endowment, insurance and pension funds from 20 years plus, while investment managers often are being evaluated on a one-year result.
- However, the good news is that short termism creates opportunities for active managers, and we try to exploit this. We believe in the old adage "time in the market vs market timing". It is a much more predictive strategy to generate alpha by moving out the time curve than engaging in short-term trading strategies. On a day-to-day basis, the return differential between the good and bad companies are more or less zero, whereas on a 10-year time horizon the spread is massive. This creates the opportunity for skilled stock-pickers. At C Worldwide, our secret sauce is seeking to understand the earnings power of a company five years out or longer and to try to evaluate the sustainability of its business model. Understanding what is essential long-term information and what is short-term noise.

The debate over short versus long-term investment is more relevant than ever today. For over thirty years we have worked hard to find long-term sustainable investments, but in recent years we have observed that the market and its participants have moved to ever shorter mindsets and holding periods. Today, the largest share of total stock market turnover is driven by quantitative, passive, and hedging strategies, where the investment horizons are compressed and long-term fundamental considerations are minimal. While we believe that this trend is a headwind both for stock markets and broader society, it does create opportunities for the longer-term investor.

## What is Short Termism?

A short-term strategy is one that focuses on what is going to happen sooner rather than what is going to happen over time. In today's society, short termism has been compounded by the decline in our willingness to wait for things. This has been driven by the "phenomenon of social immediacy", whereby we have moved towards an always-on, always available digital world. No longer do you have to wait for a retailer to have the latest fashion on the shelves. You can just buy it online. The same goes for TV shows, whereby previously you would have to wait a week for the next episode of your favorite show, today you can stream them all at once.

The overall effect is that society is overvaluing immediate rewards and forgetting the long-term plan. This leads to what the futurist Ari Wallach refers to as the "sandbag strategy" to generational challenges. One example is a politician seeking to be re-elected in a town with a flooded riverbank chooses to install sandbags instead of repairing the river once and for all, because the repair costs would create an unpopular tax increase that could jeopardize his/her re-election prospects. As these easy quick fixes dominate our modern world, you could ask if great projects like the Panama Canal would ever stand a chance of being built today?

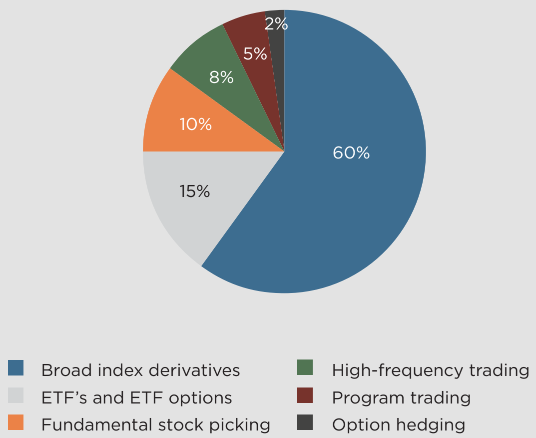
From a financial market perspective short termism – also called quarterly capitalism – is defined by a company's fixation on managing for the short term with decisions driven by the need to meet quarterly earnings at the cost of long-term investments. Short termism is usually a hindrance as it has the potential to undermine future economic growth as the lack of long-term investments ultimately leads to slower GDP, higher unemployment and lower investment returns.

## Why is Short Termism happening?

We believe the rise of short termism is happening for several reasons. Firstly, there has been a change in the market participants. As figure 1 on the next page shows, according to data from the NYSE and JP Morgan, stock-picking based on fundamental analysis only accounts for 10% of the overall turnover in the equity market. The rest is made up of equity-derivatives, ETF's and other non-fundamental investors.

**Figure 1: Change in market participants**

Share of total equity trading

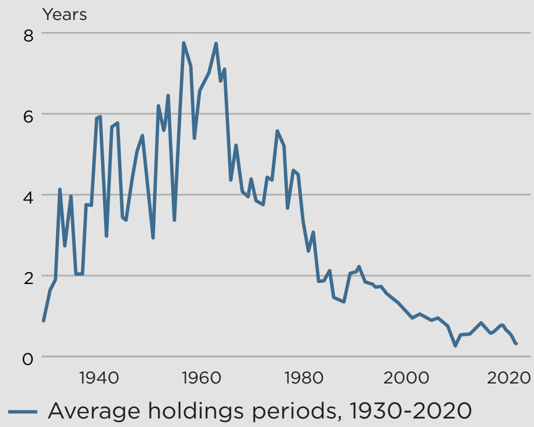



Source: Financial Times and JPM estimate as of Nov. 2019

Another change is a shorter holding period. As shown in figure 2, average holding periods have compressed over past decades from a peak of around 7.5 years to around 6 months. Part of the reason is the change in market participants but also the average time horizon of portfolio managers (PM) has become much shorter. This is highlighted by a survey by Mercer and the Generation Foundation which found that the average global PM holds a portfolio for 1.5 years. Furthermore, the study found that the average ESG fund, which invests in the long-term interests of the environment and society, only holds its portfolio for 2.5 years. This seems to be contrary to the objective of most long-term asset owners, be it pension funds, insurance funds, foundations, private family or sovereign wealth funds, which need to optimize returns over a 20 plus years horizon.

At a corporate level, another contributor to the rise in short termism has been the decline in average tenures of CEOs. Several studies have shown that the average CEO-tenure in major US companies has fallen from around 6-7 years a decade ago to approximately 5 years, while average turnover has increased by 13%. In "The CEO Life Cycle", a study of CEO performance over time by James M. Citrin, Claudius A. Hildebrand, and Robert J. Stark, the authors observed that many CEOs enjoy their greatest years of value creation only after their first decade in office. It is difficult to plan and reach long-term goals when your tenure is too short.

**Figure 2: Shorter holding periods**




Source: NYSE and Refinitiv as of Dec. 2020

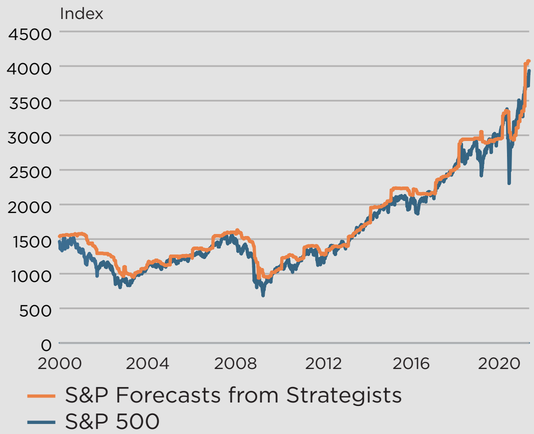
It would be remiss to discuss the rise of short termism without referring to the role of the sell-side financial community. Most sell-side analysts guided by their perceived client needs tend to focus on periods measured in quarters rather than years. While they generally have an impressive knowledge and vision of the coming quarters, many need to pause for thought when asked "what do you like on a five/ten year view"? Furthermore, their views tend to be influenced by the recent share price action. As an example, figure 3 on the next page shows the S&P forecast from strategists against the actual performance of the S&P 500. It is almost impossible to set the two lines apart, so one might ask is the opinion driving price or is it the other way around?

"The average ESG fund, which invests in the long-term interests of the environment and society, only holds its portfolio for 2.5 years. This seems to be contrary to the objective of most long-term asset owners, which need to optimize returns over a 15-30-year time horizon.

Interviews conducted by KPMG reveal that the predominant clients of equity research are short-term investors with no interest in the prospects of a company beyond a year. Furthermore, they found that investors with long-term liabilities also ask for short-term research. This perhaps rationalizes the emphasis on short-term research by the sell-side analysts.

At C WorldWide, we are looking for information that we refer to as "lasting knowledge", i.e. information with a minimum shelf life of 5 years.

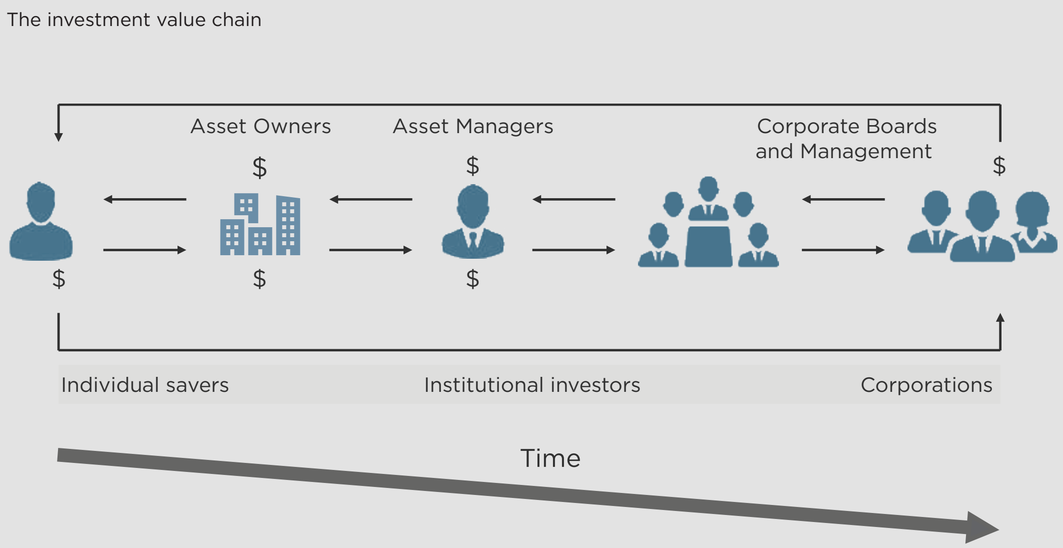
**Figure 3: Near sighted analysts**




Source: Bloomberg, C WorldWide as of Dec. 2020

Finally, and most importantly, one of the largest contributors to short termism is what "Focusing Capital for The Longer Term" (FCLT) refers to as the time-misaligned investment chain – see figure 4 on the next page. FCLT highlights that much of the capital in the chain originates from savers whose interests are long term. Yet, today few individuals directly invest their own savings. Rather, the majority of capital works its

**Figure 4: A time misaligned investment chain**




Source: FCLT as of Nov. 2019

way through the hands of multiple financial market participants before the individual savers realize a return from the net cash received on their effective investments. Unfortunately, as capital makes its way through the system, it is increasingly subjected to value-destroying, short-term forces and the savers' long-term interests are lost. Owners put pressure on fund managers leading to imperfect incentive structures, which in turn leads fund managers to put pressure on corporations and so the cycle becomes a vicious one. This issue becomes clear: if we consider that the average liability length of sovereign wealth funds is approx. 50 years, endowment, insurance and pension funds 20 plus years, while a fund manager who is chasing a one-year performance incentive in November could have a performance horizon of less than two months.

## What is the impact on companies and financial markets?

For companies, short termism leads to an extreme focus on the share price, which in turn leads to greater pressure on management. Today, management teams are often more preoccupied by their share price and making quarterly earnings forecasts potentially leading to lower long-term value creation while prioritizing payouts over reinvestment.

As testament to this, McKinsey and FCLT have researched the 'greater pressure on management' concept – see figure 5 on the next page – and found that 87% of management teams feel pressured to demonstrate strong financial performance within 2 years or less. 65% interviewed found that short-term pressure has increased over the past 5 years. Even more worrying, companies without a strong long-term culture said that they would delay a new project to make quarterly earnings forecasts even at the expense of longer-term value creation.

This pressure has also led management teams to over emphasize and target analyst metrics such as capital returns instead of more strategic goals. We encourage companies to return capital to shareholders and companies must pay high attention to their cost of capital, although not at the expense of future growth.

**Figure 5: Greater pressure on management teams**

Surveys show that executives are feeling pressure from short termism

87%

Feel most pressured to demonstrate strong financial performance within 2 years or less

65%

Say short-term pressure has increased over the past 5 years

55%

Companies without a strong long-term culture say their company would delay a new project to hit quarterly targets even if it sacrificed some value

Source: McKinsey, FCLT Global as of Sep. 2016

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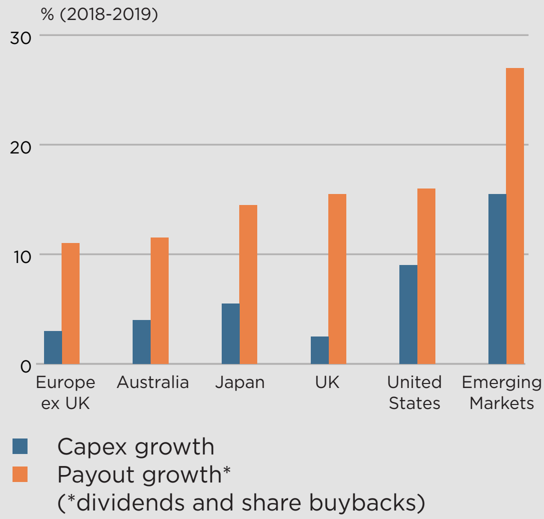
**Today, management teams are often more preoccupied by their share price and making quarterly earnings forecasts potentially leading to lower long-term value creation while prioritizing payouts over reinvestment.**

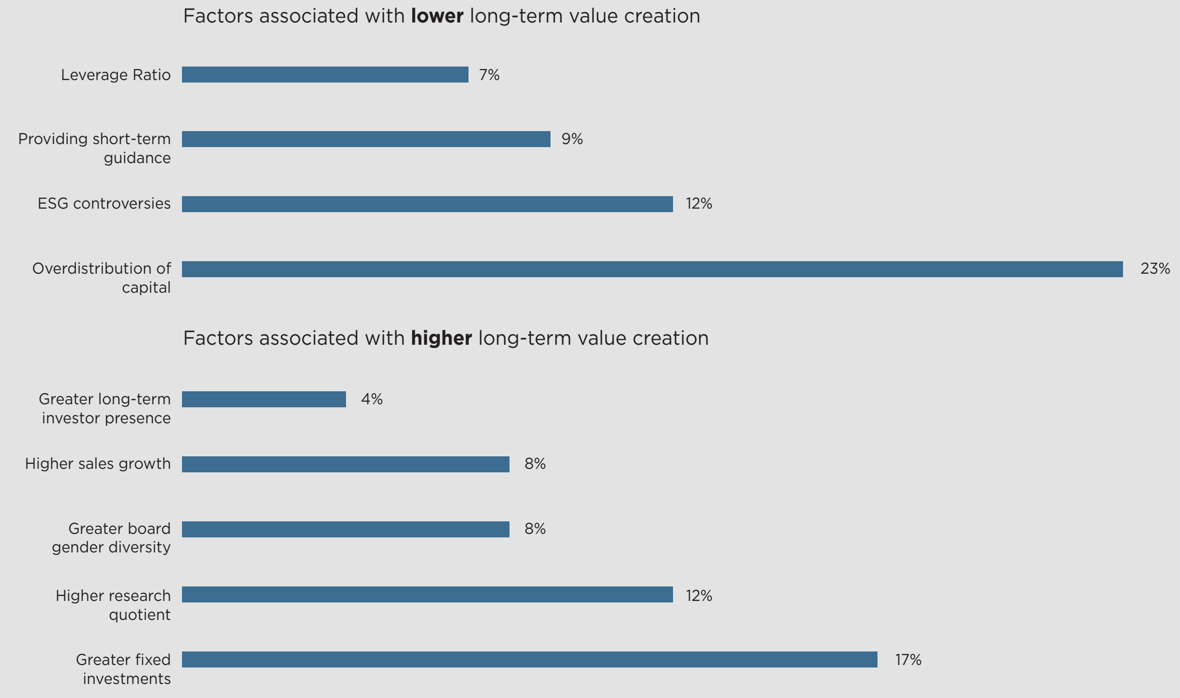
As shown in figure 6, companies in the S&P 500 in 2019 repurchased shares for close to a trillion US dollars and paid out close to 500 billion US dollars in dividends. That equates to almost 98% of 2019 earnings. The growth in payouts has outgrown capex growth, and capex growth is what drives future growth.

**Figure 6: Focus on analyst metrics - buy backs**




Source: Datastream, Citigroup, C WorldWide as of Dec. 2019

**Figure 7: Leading to lower long-term value creation**



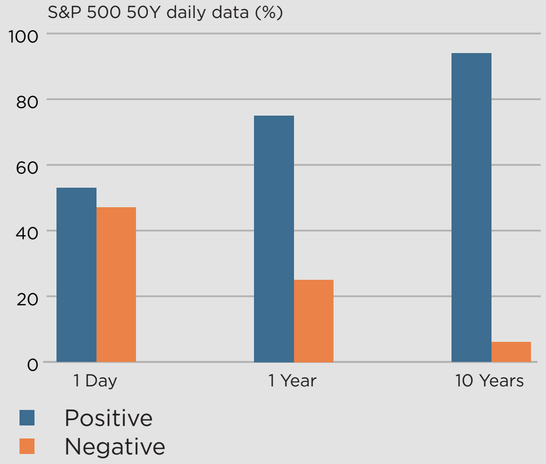

Source: FCLT using MSCI ACWI universe and using ROIC and TSR as ranking variables, as of Dec. 2019

At C WorldWide we manage capital for the long term and we look at factors associated with longer-term value creation. In our view, the narrow focus on analyst metrics such as payout growth, risks not only reducing the future earnings growth of a company, but also of the overall economy leading to lower long-term value creation. Figure 7 shows significant evidence that the biggest factor associated with lower long-term value creation is overdistribution of capital. Likewise, the biggest factor associated with higher long-term value creation is greater fixed investments.

## How do we think about investments horizons?

First, we are big believers of the old adage "time in the market vs. market timing". Time horizons matter and by extending them you create opportunities. Figure 8 proves this and shows that if you invested in the S&P 500 with a one-day time horizon measured over 50 years, the outcome is 53% positive and 47% negative –almost a flip of a coin. Conversely, longer-

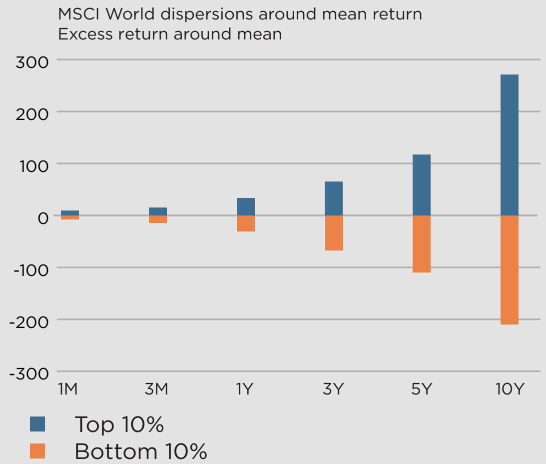
**Figure 8: Time in the market vs market timing**




Source: Bloomberg as of Jan. 2021

term investment periods show that the investment opportunity gets better with the passing of time. For example, after 10 years you would have had a 94% opportunity for a positive investment experience.

**Figure 9: Time horizons matter**



Source: Bloomberg and C WorldWide as of Dec. 2020

Also, time horizons matter for a different reason, as depicted in figure 9 above.

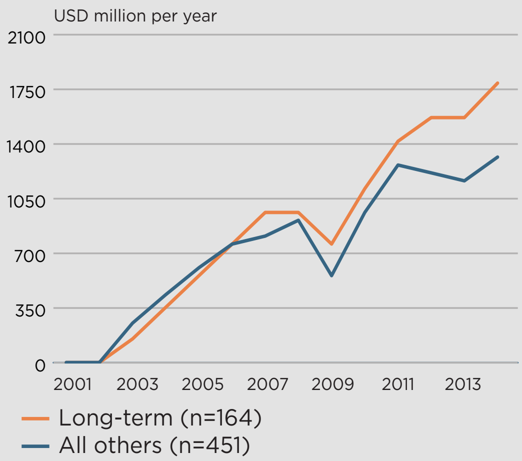
As portfolio managers we try to take advantage of the market dispersion over time by picking the winning companies while avoiding the losers. We are strong believers that over the longer term, there are few companies that really can create attractive returns. Figure 8 shows the dispersion of returns between the top decile and bottom decile of constituents of the MSCI AC Word Index. Over a 1-month period the difference between the top 10% and the bottom 10% is around 17%. But over time the spread keeps increasing. Over a 10-year period there is a massive spread between the top and bottom 10%. As active managers we try to exploit this. It is much easier to achieve alpha by moving further out the time curve than when investing with short holding periods.

## The sustainable appeal of long-term investing

We feel strongly that the impact of short termism or importance of taking a long-term view often gets over-looked when considering ESG matters. Figure 10 and 11 show the results of a study of over 600 US companies over a 15-year period.

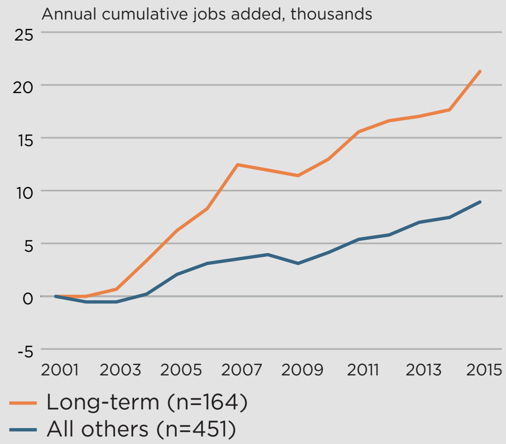
The companies were divided into two groups, one deemed long-term companies using several key factors with the remainder being all other companies. Among the factors used were above average spending on research and development and capital expenditure, not managing earnings on a quarterly basis, higher

**Figure 10: Average company earnings**



Source: McKinsey Corporate Horizons paper as of 2017

**Figure 11: Average job creation**

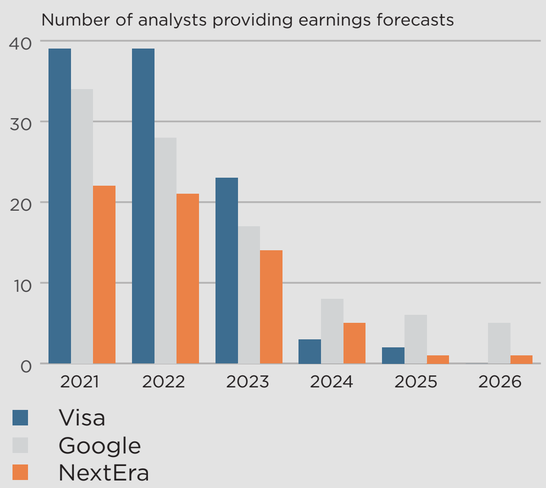


Source: McKinsey Corporate Horizons paper as of 2017 sales growth and a diverse board representation. These companies were selected on a sector neutral basis. What McKinsey found was that the long-term orientated companies outperformed all the other companies by 36% in terms of earnings over a 15-year period. Perhaps more importantly, these companies created nearly 12,000 more jobs. This can be explained by the apparent willingness of long-term companies to invest also in difficult times and thus creating more economic value over time. From an economic point of view, if all companies behaved like long-term companies, the study concluded that the US would have created an extra 1 million jobs annually, equating to 1 trillion extra of GDP value over that 15-year period.

According to the UN Sustainable Development Goals (UNSDG), goal number 1 is zero hunger and number 2 is zero poverty while goal number 8 relates to decent work and economic conditions. In our opinion, these are among the fundamental building blocks to many of the other goals. In other words, if you don't achieve the basic goals 1 and 2, and you don't have job creation, the other goals are likely to be more difficult to achieve. Therefore, we think that long-term investing and sustainability go hand-in-hand.

We believe this creates opportunities. At C Worldwide, when looking at a potential investment candidate we try to understand the earning power of the company five years out or longer and try to evaluate how sustainable those earnings are likely to be. This long-term perspective is one way we strive to add value and generate alpha.

**Figure 12: Short termism creates opportunity**



Source: Bloomberg as of Jan. 2021

## Short Termism Creates Opportunity

A key take-away is that short termism can create opportunities for the longer-term focused investor. To illustrate, figure 12 shows three of the companies in our global equity strategy and the number of analyst forecasts for each calendar year. As can be seen in year one there are 39, 34, and 22 earnings forecasts for Visa, Google and NextEra, respectively. These are relatively high coverage ratios. But note how the coverage declines as you move out to year 2025 and 2026, the number of forecasts decline to a maximum of 6 and 5 for each year for Google and 2 and 1 for Visa and NextEra, respectively. Are the business models of Visa, Google and NextEra that complicated and unpredictable that they do not warrant explicit forecasts? We think not. More likely, the analyst community is neither motivated nor incentivized to make explicit forecasts beyond the immediate future.

## Our Process

When buying a company we look for the power of compounding. In this journey, we analyze and evaluate the earning power of a company for at least a 5-year period. We take an owner approach to capital allocation and we prioritise a strong company culture. Our investment companies should have strong, growing addressable markets – for example products that are benefitting from the transition from offline to online. Also, for companies that are exposed to strong generational themes and trends – for example companies exposed to the theme 'digital society'. Not least, we look for a favorable market structure and ideally market leaders that have above average and sustainable revenues and earnings growth, and most importantly a sustainable approach to capital allocation.

Our three major sources of alpha are to identify the compounding trajectory for a company preferably at an early but still at a well-defined, low risk stage, to have an independent opinion on available information combined with an understanding of what is important and what's not – and lastly, the long-term perspective.

Longevity, sustainability, growth, and good returns go hand-in-hand. For us, this is not a new insight. This is how we have always worked. We are convinced that this will become clearer and more important in the coming decades, and we believe that investors have everything to gain by understanding the dynamics between long-termism and short-termism.

# Active Investments

C WorldWide Asset Management Fondsmaeglerselskab A/S is a focused asset manager. Our objective is to deliver consistent, long-term capital growth for clients through active investments in listed equities on global stock exchanges.

Our clients are primarily institutional investors and external distribution channels. The combination of a unique investment philosophy based on careful stock picking and long-term global trends coupled with a stable team of experienced portfolio managers, has since 1986 resulted in world-class investment performance.

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