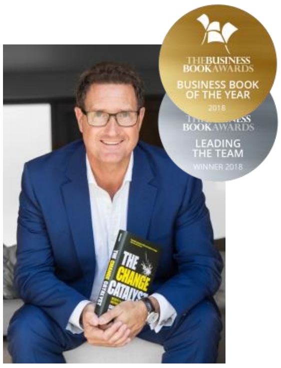

What does it mean to be a (genuine) Long Term Investor?

London 4 May 2018. Speech at the SII West Round Table.

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Good morning. It is a privilege to be here. What I am going to talk to you about this morning is my view on what it means to be a genuine long term investor.

But first I have a confession to make: I am not an investment guy.

I'm a strategy guy. At an M&A conference in Florida last month, I was introduced as 'The C Suite Change Guy'. 6 weeks ago, my book, **The Change Catalyst** won the award for the Best Leadership book and the overall title of 2018 Business Book of the Year at the recent Business Book Awards in London.

I help CEOs, CIOs and leadership teams clarify their strategy, build cultures that embrace change and align their organisations to deliver.

So, I bring a different perspective to this topic – it is the perspective of the outsider of sorts – bringing to the table what Richard Branson used to describe his perspective whenever he entered a new industry – 'Intelligent Naivety'.

And as some company I have never heard of put is so brilliantly: 'The best way to bring in new ideas to your company is to hire an outsider.'

Every asset owner I have met says they are a long term investor - in much the same way that every CEO declares that their greatest asset is their people – automatically and often without thinking about it too much.

I have attended dozens of investment and asset allocation conferences over the years and have started to wonder if being a long term investor has become something of a throw-away line – or perhaps it is just that many of us just haven't paused to properly define it for our organisations.

So today, I am going to do two things:

1. Bust some myths that I see about Long Term Investing

2. Give you my view of what a long term investor looks and feels like. I will put a straw-man definition out there for you to think about, disagree with, throw rocks at and hopefully find a few nuggets of value amongst the quotes and cartoons.

Let's get started.

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Mythbusters

During the last four of five years, I have heard many comments and witnessed many stances on the subject of long term investing – and many of them seem to go unquestioned. Let's take a look at some of them.

Myth 1: The definition of Long Term depends upon your investment horizon.

This isn't so much a myth as it is a distraction. Or as a colleague of mine would describe it – a BGO – a 'Blinding Glimpse of the Obvious'. One conference I attended last year took 45 minutes to debate the subject and this was the conclusion. By disappearing down this rabbit hole, we ran out of time for meaningful discussion. Of course the definition of Long Term depends upon your investment horizon. And of course your investment horizon will depend upon your fund's liabilities and cash flow requirements. And yes, for some investors, 'long term' can be 10 years, for some 30, for others multi-generational.

But this debate is a distraction. Let's just agree that long term investing must be of a duration of at least one investment cycle (7-10 years) … and swiftly move on to define precisely what being a long term investor actually means to your organisation.

Myth #2: Long term investing means "hands off the tiller". No-one actually says this out loud but sometimes actions can speak louder than words. Yes it is true that some of the best investment decisions have been to do nothing. Staying calm during a downturn is indeed a critical quality of any long term investor. Panicking and selling at the wrong time of the cycle has ruined many a portfolio. Those funds who sat on their hands during the Great Recession came out the back of it in damn good shape. However, complacency can also be a killer. In fact, I dedicate a whole chapter of the book to it.

If we are not careful, the phrase "It's OK. We are a long term investor" can be used as an excuse for poor short or medium term performance. This is dangerous.

Performance setbacks are actually a brilliant opportunity to reflect and learn. "What caused the setback? Could it have been foreseen? Could we have done anything differently? Should we amend our research or decision-making processes in light of this new insight?" Rather than seeking to avoid blame for previous investment decisions, let's learn from them.

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Myth #3: Long term just means following the index. This is closely aligned to myth #2. Obviously passive investing is an important part of almost every institutional investor's armoury and it is often a politically safe way to invest large sums of money, but indices are far from perfect. They are snapshots in time. The companies in the main indices are selected on the basis of today's market capitalisation and while future profits play some role in the calculation, it is not an overt assessment of the company's sustainability or longevity. After all, only 28 of the original FTSE 100 companies remain in the index today, 34 years later.

The flow to passive funds continued during 2017 and one of the reasons behind these flows was the relatively poor net performance of so many active funds over the preceding years. While fees are always stated as a reason for moving out of active funds, it does appear that many institutional investors switched due to short-term performance.

Myth #4: Long term means investing in 'illiquid' assets. Some investors point to their investment in the so-called 'illiquid' asset classes of Real Estate, Private Equity and Infrastructure as proof that they are a Long Term Investor. It isn't. The inclusion of these asset classes are simply indications of a diversified portfolio.

I also question precisely how illiquid these asset classes really are. There is an excess of capital waiting to be deployed in all of these asset classes. There is more than $1 Trillion of "dry powder" of PE waiting to be deployed. If the US ever manages to release infrastructure bonds, they will be oversubscribed hundreds of times over.

But my key point here is that, as a Long Term Investor, we are investing for the long term across every asset class – not just in these three. Locking up capital in a real estate project or a PE fund should be no different to locking up capital in publicly listed stocks. The fact that you could sell your public market equities at the drop of a hat doesn't mean you should – or will for that matter.

Undoubtedly, one of the many advantages of Private Equity is that it enables company boards and management to take a longer term view rather than become distracted by the burden of quarterly reporting. But as Long Term Investors, we need to work against such short-termism anyway.

Long Term Investors take a long term view of the companies they invest in – no matter whether they are privately held or publicly listed.

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Myth #5: Long term investing means activism.

It doesn't. This extreme viewpoint seems to arise from activist investors claims that they are in the best long term interests of shareholders; that they are the catalyst that complacent companies need to sharpen up and prepare for the future. Sometimes this may be true but too many times activist groups are actually disruptive short-term investors seeking to achieve a short-term spike in share price by slashing staff numbers and R&D spend. Sovereigns in particular are not activist investors and they never will be. That's a good thing. But I do believe they should be 'engaged' investors – which we will get to later.

Myth #6: The long term is really just a series of short terms. These are the exact words that the CEO of one of the world's leading active fund managers said to me: "We don't believe in long term. Long term is just a series of short terms." This is my favourite myth for the simple reason that it is obviously true in a very literal sense. It is certainly true that an extra dollar gained, or even saved, today will be worth several dollars after decades of compound growth. But the inherent short-term nature of the statement is fraught with danger.

As McKinseys and FCLT Global (Focusing Capital for the Long Term) demonstrated in their excellent Feb 2017 white paper, *'Measuring the economic impact of short-termism'* (www.fcltglobal.org), far too much shareholder value is being lost by the corporate world's obsession with quarterly reporting cycles and an unwillingness to invest in R&D and building capability for future growth.

According to the FCLT/McKinseys report, between 2001 and 2014 long term oriented companies:

- Invested 50% more on R&D than other firms
- Created 12,000 more jobs per firm
- Received 47% higher revenue
- Enjoyed 36% higher earnings
- Delivered 81% greater economic profit
- Chalked up $7bn higher market cap per firm over that period

Short-term thinking has resulted in an estimated $1 Trillion of foregone GDP over the last decade.

And 65% of executives feel that short-term pressure has increased over the last five years. Plus:

- 87% of company executives and directors feel pressured to demonstrate strong financial performance within the next two years or less.
- 55% say their companies would delay value-positive project to hit quarterly targets.
- 55% of CFOs would forego a positive NPV investment if it meant missing EPS consensus by just one cent. 47% of CEOs agreed with them.

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So what <u>does</u> it mean to be a Long Term Investor?

Here are my top ten:

1. It is about attitude.

Being a Long Term Investor is about attitude, not timeframes. It requires a confidence based on clarity of purpose, clarity of the outcomes that the organisation requires, clear research and insightful analysis. A Long Term Investor is bold enough to speak up about the dangers of short-termism and brave enough to address the issue within their own organisation.

2. **Culture is the key.**

Culture is the key to organisational performance.

An organisation gets the culture that its leaders create.

UK politics demonstrated this fact very clearly just this week. At the start of the week, Home Secretary Amber Rudd resigned from the Cabinet for 'inadvertently misleading parliament'. She told parliament that the Home Office did not have targets for removing illegal and undocumented immigrants – which was subsequently found to be untrue. In reality, she presided over a Home Office with a culture that was looking for any opportunity to remove people from the country, which in turn has led to the deportation of thousands of people who have been legally living, working and paying taxes in the UK for many decades. This was all set in motion by the previous Prime Minister, David Cameron, and his Home Secretary, Theresa May, when, scared by the surge in popularity for UKIP, they pledged to reduce immigration from hundreds of thousands a year to 'tens of thousands' – an ambitious target that the Home Office then set about implementing. An organisation gets the culture its leaders create.

One of the best definitions of culture is this one I found several years ago: "A company's culture is how people behave when they think no-one is watching." But unfortunately, this remark was said by Bob Diamond, the CEO of Barclays, just weeks before he was forced to step down due to the Libor fixing scandal.

So here are some questions for you about your culture:

- Does the leadership of your organisation focus on the long term or is it overly concerned with quarterly/half-yearly/annual performance?
- Is the leadership consistent?
- Does it genuinely encourage people to challenge the status quo?
- Does it review major investment decisions to learn lessons from the experience?

Culture change requires clarity and true leadership. True leadership requires genuine engagement with your people.

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3. Strategic Clarity

Strategic clarity is a pre-requisite for success for any organisation – and in my view this is particularly true for long term investors because without clarity, your people can be rowing in any and every direction – often against one another.

Ask yourself:

- Does the organisation have clarity of what it is trying to achieve, why and how?
- Does it have a strategy document? If yes, is it clear?
- Has the organisation defined what it means to be a long term investor?
- Has this been made relevant and applicable to all departments?

4. Alignment of incentives

Incentives drive behaviours. Behaviours drives results.

How are you incentivising your people to think, act and deliver like Long Term Investors?

Let's be honest – this is a challenge. How do we bridge the gap between the organisation striving to optimise long term investment performance over 10, 20, 30+ years and the relatively short-term nature of a) our careers and b) the need to remunerate people annually?

Here's how a few institutional investors tackle the problem:

- One large institutional investor has decided that a step in the right direction is to measure performance of their portfolio managers over a blend of 1, 3 and 5 year performance. They recognise this isn't perfect. That it isn't really measuring long term performance at all (seeing as the average of this blend is something like 2.7 years) – but it is an attempt.

- One sovereign fund goes to the other extreme and uses a 30-year rolling benchmark as the basis for a good chunk of the remuneration of its most senior executives. Of course, this too has its drawbacks as once a 30-year trend starts to go one way or the other, it can take a decade to change its trajectory.

- Another fund has decided to tackle this issue by giving senior executives a large amount of discretion regarding the bonuses of their people. Of course, this ends up delivering inconsistent outcomes. For some investment departments, the link between pay and performance is so opaque it hardly exists.

- One approach I do like is how the kiwis do it. Why is it that they always tend to implement good ideas before everyone else? Everyone at NZ Super receives a bonus of up to 20% of their salary tied to what they call the 'how' – how they do what they do – how they behave. The desired behaviours are clearly articulated and aligned to the organisation's culture, and values. People are rated on how well they collaborate, how well they add value to the organisation; on whether they live and breathe the values of a long term investor. I think this is a great idea, for as I said earlier – behaviours drive results. So why not drive the right behaviours? Yes, this is a challenge to properly. It requires a great deal of thought and planning – but it makes so much sense.

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In my opinion, the best answer is really a blend (which again is what NZ does) – of overall fund performance, individual performance, perhaps team performance and behaviours.

The way you incentivise your people to deliver long-term investment performance must be aligned to your culture and designed to deliver the behaviours and outcomes you are looking to achieve. And when you are designing the remuneration scheme – I implore you to think through the implications because the law of unintended consequences inevitably looms large when it comes to financial incentives. Incentives drive behaviours. Behaviours drives results.

5. Acknowledge the grey areas

No strategy is perfect and no strategy should be uniformly applied - there will always be grey areas; there will always be exceptions that prove the rule. This is especially true when it comes to long term investing.

The whole fund is a long term investor. But does this mean that every department is themselves a long term investor? Not necessarily.

Your internal active equities department may be a case in point. If you were to benchmark these sector specific PMs against a 30 year performance metric, they would simply "put it all in healthcare and technology and go home" to quote a former colleague of mine. Even if much of this department is focused on short and medium term performance - it is still part of the greater whole and the research and analysis done by this department can benefit other parts of the organisation. Which of course is why rewarding behaviours is so important. If a proportion of everyone's bonus is linked to the same corporate behaviours or overall fund performance – the potential for genuine teamwork and better outcomes for the whole group will be massively increased.

6. Invest in sustainable companies

Long term investors invest in sustainable companies.

By sustainable, I don't just mean environmentally friendly and ethical. I mean companies with sustainable business models that are likely to be around for the long term. This obviously includes the standard measures of market share, profitability, market access and revenue growth but should also include culture. Is their culture one that embraces change? How does the leadership avoid complacency? Is their risk management and governance appropriate and does it work? How does the company treat its employees? Its partners? Its suppliers? The societies in which it operates? Does it pay tax or does it dodge tax? And yes, is it environmentally sound?

All of these are factors that will determine whether it is sustainable or not. Actually all of these questions are also valid for your organisation – after all you need to be sustainable in the long term as well.

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7. Long term mega trends.

Our world is changing at an unprecedented rate. The 'new economy' minnows of 20 years ago are now the biggest corporations in the world and have disrupted entire industries. They too will be disrupted.

- Urbanisation
- The internet of things
- Population growth: The world's population has increased 5 fold since 1900 to more than 7 billion. It is forecast to reach 9 billion in 20 years' time.
- Average human life expectancy has doubled in the last century – this is set to continue to increase – for the wealthy anyway
- An explosion in livestock is devastating our environment
- New energy sources are being developed at a rapid rate.
- Globalisation has disrupted entire industries and, when combined with global political complacency, has created a large under-employed underclass in the West.
- AI and Automation is set to make this look like a picnic. Ray Kurzweil, futurist and a director of engineering at Google predicts that, by 2029, "the manufacturing, agriculture, and transportation sectors of the economy will be almost entirely automated". We could add financial services, the legal profession, accountants and even doctors to that list. Computer programmes can now diagnose cancers from X-Ray images more accurately than some of the best oncologists.

How does your organisation capture and analyse long term trends – and more importantly, how does this insight manifest itself in your investment strategy?

It doesn't matter how big your research department may be. It doesn't matter how many clever macro-economists you hire or how many technology, political, sociology or environmental experts you have on tap, if your organisation isn't ready, willing and able to deliver – it will all have been a complete waste of time and effort. *Strategy without execution is a daydream*. (The other half of this pithy saying is also valid – *Execution without strategy is a nightmare*.)

7. Fight against short-termism.

Long Term Investors speak out against short-termism, realising that the battle may be a long one but that winning it is critical.

Short-term thinking is ingrained in the investment industry. At a long-term investing conference I attended last year, the CEO of a large pension fund was talking about the relatively new S&P Long-Term Value Creation (LTVC) Global Index and went on to apologise for the fact that the first six months' performance was not stellar but that the index had rebounded in its second six months. The irony of the moment was not lost on the audience. When one of the most vocal exponents of long-term investing feels compelled to defend the short-term performance of the new long-term index – it just shows how ingrained this short term thinking is – and underlines the fact that we need to be vigilant in our fight against it.

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8. Be brave enough to be counter-cyclical

Long term companies are brave enough to be counter-cyclical. If a leadership team believes in its business model and strategy, the best time to invest in people development, R&D, advertising and market-share building activities is during a downturn. The same philosophy is true for Long Term Investors. If you are clear about your investment principles and genuinely believe in your investment strategy, the best time to invest is in a downturn.

Do you possess the liquidity to not only cover your liabilities but to 'double down' when markets dip? Do you have the corporate will to be counter-cyclical?

9. Be an 'engaged' investor

Not an 'activist' investor but not entirely passive either. But I would encourage long term investors to 'get engaged' with the companies they invest in.

Long Term Investors invest in companies that are likely to be around for the long term. They invest in companies with sustainable business models and long term strategies.

Companies that mainly operate for the benefit of their senior executives are not sustainable in the long term – as Australia's recent Banking Royal Commission has amply demonstrated. Long term investors invest in companies that deliver value for the entire ecosystem in which they operate – customers, employees, suppliers, partners, the communities in which they operate –as well as shareholders and senior executives.

Long Term Investors invest in companies that understand the value of R&D and invest in building long term capability.

Long Term Investors engage with the organisations in which they invest; either avoiding companies who are obsessed with short-term reporting or working with them to change.

Even predominantly 'passive' Long Term Investors can encourage corporations to start acting and thinking long term – for the benefit of their shareholders, employees and customers alike. Larry Fink's recent letter to CEOs attempts to do precisely that.

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10. Synergistic partnership with your asset managers.

Obviously, switching asset managers due to short-term performance is not in line with a genuinely long-term investment strategy. Measuring performance over 1, 3 or even 5 years also makes little sense – if you are a Long Term Investor.

Here are a few questions that FCLT recommends you ask yourself as you negotiate when it comes to Long Term mandates

1. Do the incentives built into the mandate support a long-term relationship?

For example, fees that decline with the longevity of the partnership rather than with the assets under management may provide owners incentives to be more patient through periods of underperformance.

2. Do the ongoing communications concentrate undue attention on short-term results?

Simple changes, such as emphasizing long-term returns in performance reports, highlighting annual (or multi-year) instead of quarterly performance, and defining a rebalancing policy, may counteract the impulse to overreact to short-term events.

3. Is the focus on leading or lagging indicators of performance?

Disclosure of changes in the firm or team, shifts in the investment process, and results measured by key performance indicators (KPIs) may provide an owner with more insight into future performance than current or past performance does.

4. Do the mandate terms reward long-term investing and mitigate the common "buy-high, sell-low" pattern of chasing performance?

It is tempting to invest in managers after strong performance and terminate them after poor performance, leading owners to chase rather than capture strong returns.

Perhaps the best way to select your long-term asset managers is to judge them on many of the same factors that I talked about earlier – on attitude, culture, leadership, how they remunerate their investment professionals, how engaged they are with the industries and companies in which they invest, how they take advantage of long term trends, the clarity of their firm's investment strategy and whether their company lives and breathes it, their own financial sustainability, how they react in a downturn and whether their interests are aligned with yours.

After all, asset owners and asset managers alike want to partner with genuine Long Term Investors.

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Long Term Investors plan to be around for the long term.

This may sound like yet another Blinding Glimpse of the Obvious but Long Term Investors also need to be sustainable themselves. This requires:

a) strategic clarity (clarity of purpose, measurable outcomes based on objective analysis, clarity of comparative advantages, clear investment principles and investment strategy, clarity of accountabilities, clear governance and decision-making processes, …),

b) clarity of financial liabilities and future cash flows,

c) a sustainable business model that is as cost-effective and productive as possible,

d) clarity of what it means for your organisation to be a long term investor, and

e) every department and every employee understands the part they play in achieving the fund's long term objectives.

How well does your organisation measure up against these criteria?

Because it is all about achieving the best outcomes – in the long term.

And we are all long term investors.

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