

# The Case for Long-Termism

## Keith Ambachtsheer

Keith Ambachtsheer is Director Emeritus of the International Centre for Pension Management at the Rotman School of Management, University of Toronto (Canada), and Editor of *RIJPM*.

*In their 2014 article in Harvard Business Review, Dominic Barton and Mark Wiseman write that “big investors have an obligation to end the plague of short-termism.” This article supports their assertion by showing that, logically, real investing (as opposed to trading) is inherently wealth creating and long-term in nature. However, powerful short-term forces stand in the way of this kind of investing. The article provides evidence that when these short-term forces are neutralized, executing long-term investment strategies that generate positive multi-decade excess returns becomes a realistic possibility.*

*Keywords: Abductive Reasoning, Agency Theory, Asymmetric Information, Behavioral Finance, Fiduciary Duties, Investment Beliefs, Long-Term Investing, Pension Fund*

## The Deductive Case for Long-Termism

The *Oxford Dictionary of English* defines deductive logic as “using knowledge about things that are generally true in order to think about particular situations and problems.”<sup>1</sup> Can we use this “from general to particular” thought process to make the case that long-termism is fundamental to the creation of societal wealth and well-being? I think we can.

Without long-termism, we would still be living in the same subsistence societies our forebears did, continually on the edge of starvation. We would be facing the same life-or-death decisions between consuming what is produced now and saving part of it in the form of seeds, implements, and shelter for tomorrow. Necessity required these societies to take a very short-term view of things to survive. This strong bias for today at the expense of tomorrow means that, in financial terms, our forebears implicitly used very high discount rates when making saving / investment decisions for tomorrow.<sup>2</sup>

Eventually, difficult saving / investment decisions – in the form of seeds, implements, and shelter – began to be made, and, predictably, these decisions made all the difference. These early investments were followed by places of worship and by roads, carts, carriages, and ships to explore and trade in the wider world. After that came the inventions that powered the first Industrial Revolution, which ultimately gave us trains, automobiles, and planes, to be followed by a second one that produced the Internet, e-commerce, and instantaneous, ubiquitous channels of communication. A parallel series of social and legal

revolutions gave us property rights, representative democracy, limited liability, universal education and health care, the middle class, financial markets, and pensions.<sup>3</sup>

Logically, as the stock of wealth-producing capital accumulated over the course of centuries, there was a parallel decline in the physical need to consume all that was produced. With both the capital stock and the savings rate increasing, the discount rates used to make savings/investment decisions began their natural decline. These lower discount rates, in turn, enabled entrepreneurs to take an even longer view in making their investment decisions, leading to an even greater rate of wealth-producing capital formation.

What was the linchpin that held this remarkable rags-to-riches story together over the course of time? Surely it was our discovery of the wealth-creating logic of shifting from a mindset of day-to-day survival to one that stretched out to next week, next month, next year ... and eventually out decades and even centuries. It was this shift towards being able to think and invest in ever longer time frames that made possible the eventual transformation of the subsistence societies of long ago to today’s far wealthier, more stable ones.

### **What about Tomorrow?**

And what about tomorrow? Have we now arrived at the end of history, as some claim? Or is there still a higher plateau of civilization that we can and should aspire to? I share the views of William Bernstein (2013), and to his four reasons for answering “yes” to the latter question,<sup>4</sup> I add a fifth:

1. **Scientific rationalism:** It is unduly pessimistic to assert that all things worth discovering or inventing have been discovered and invented. New discoveries and inventions will likely continue to accumulate and add to societal wealth and well-being, though they may be more difficult to find and require longer gestation periods.
2. **Property rights buttressed by the rule of law:** Evidence in support of this long-horizon prosperity factor is overwhelming. Wealthy developed economies acquired a clear property rights advantage centuries ago, while it is still a work in progress in poorer developing ones.
3. **Well-functioning capital markets:** It was one thing for Edison to invent and patent the incandescent light bulb; it was quite another to mass-produce it and to build the power-generation and transmission systems for millions of people to benefit from it. These undertakings required transforming savings through financial markets into long-horizon, wealth-producing capital on a large scale.<sup>5</sup>
4. **Modern communication and transportation technologies:** It is not sufficient to simply produce the goods and services consumers want; people must also know they exist and be able to easily acquire them.
5. **Continued population growth on a finite planet:** The world's population was 2.5 billion in 1950; today it is 7 billion. New requirements for sustainable investment in food production, clean water, shelter, health care, education, energy, and transportation in developing economies logically follow. Climate change also brings its own set of investment imperatives.

There is an important caveat to this positive view of the prospects for continued wealth creation and improved well-being in the twenty-first century and beyond:<sup>6</sup> it assumes that today's and tomorrow's public and private investment decisions will be made in time frames long enough to capture the challenges and complexities of the societies in which we now live. In short, it assumes a world in which "responsible long-termism" will be the dominant investment paradigm.

### ***Long-Termism in a Society of Agents***

However, such "better tomorrows" outcomes are by no means guaranteed. Why? Because today's societies are far more complex than the simple subsistence societies of long ago. This complexity creates a need for expert agents to perform services in spheres where ordinary people (citizens, savers, investors) are no longer able or willing to act on their own. These (presumptive) expert agents act in one of several possible spheres, including government, commerce, and finance.

Our countries are no longer ruled by hereditary kings, dukes, and their coteries of lesser nobles and henchmen; governments are now complex organisms headed by hundreds of elected "agent" representatives, who are in turn supported by many

thousands of public-sector "agent" professionals and workers. Today's public sectors control between one-quarter and half of all revenues and expenditures of national economies in the developed world. On the one hand, the typical four-year (or less!) election cycle places a material misbehavior constraint on elected public sector agents; on the other, the shortness of the cycle also potentially constrains the full exercise of responsible long-termism by these agents.

In the commercial sphere, most of us no longer run our own subsistence farms, inns, or ironmongers' shops; instead, we work for small, medium, or large enterprises of increasing complexity. The larger the enterprise, the more likely it is that its owners do not also manage it; instead, they elect a board of agent directors to represent their interests. These agent directors, in turn, hire an agent CEO to manage the enterprise, and the agent CEO in turn hires a team of fellow agent managers to assist in running the business. A world with this kind of separation of ownership and control is not a world in which responsible long-termism is automatically the dominant decision paradigm.<sup>7</sup>

In addition to political and commercial agents, modern societies have spawned a third kind of agent: the finance/investment agent. The demand for this kind of agent arises naturally in societies where savings are intermediated through financial markets in the form of debt, equity, and other financial instruments; the more complex financial markets become, the greater the demand for expert finance and investment agents. Savers can deal with these agents either directly or indirectly, through intermediary organizations such as banks, insurance companies, pension funds, or retail mutual funds. Either alternative separates ownership and control, and once again, this is not a world in which responsible long-termism is automatically the dominant decision paradigm.

### ***The Asymmetric Information Problem***

George Akerlof was awarded the 2001 Nobel Prize in Economics for the profound idea that the classic "value-for-money" outcomes attached to market competition require informational symmetry between buyers and sellers. If sellers (with generally short horizons) know more about what they are selling than buyers (with generally long horizons) know about what they are buying, the sellers will be able to extract too high a price from buyers for too little value.<sup>8</sup> This asymmetry goes to the heart of the political, commercial, and finance/investment agency contexts set out above. In a complex world, political agents will know more about the costs and benefits of competing infrastructure investments than the average citizen; commercial agents will know more about the costs and benefits of making a corporate R&D investment than the average shareholder; and finance/investment agents will know more about the costs and benefits of competing investment strategies than the average client.

None of this would matter if the financial interests of agents and principals in these three contexts were always perfectly aligned. But that is not necessarily the case. It is entirely possible that while Infrastructure Project A best serves the greater good in the long term, Project B best serves the short-term political interests of the governing party. Similarly, it is entirely possible that while a proposed corporate R&D project best serves shareholders' long-term interests, not proceeding with the project best serves management's interests by boosting next year's earnings, and hence its own compensation. And, finally, it is entirely possible that while Investment Strategy A is in the client's best long-term interests, the agent will choose Strategy B because of its greater fee-generating potential. This is not just theory. As an example, there is a strong *a priori* case that because the retail mutual fund sector is burdened with materially higher agency costs than the pension fund sector, it should have higher costs and lower net returns – and this is indeed the case (see, e.g., Bauer, Cremers, and Frehen 2010).

### **Key Writings on the Principal–Agent Problem: A Short Synopsis**

The principal–agent problem is not new. In a commercial agent context, Adam Smith (2000 [1776]) noted the problem in the world's first opus on capitalism, *The Wealth of Nations*. For example, he wrote of corporate directors that, “being managers of other people's money, it cannot be well expected that they should watch over it with the same anxious vigilance ... as their own” (Smith 2000 [1776], 439). Adolf Berle and Gardiner Means (1932) formalized the implications of the separation of ownership and control in a more modern setting in *The Modern Corporation and Private Property*; their observation about corporate boards was,

*Just what motives are in effect today ... must be a matter of conjecture. But probably more could be learned about them by studying the motives of an Alexander the Great ... than by considering the motives of a petty tradesman in the days of Adam Smith. (Berle and Means 1932, 308)*

Michael Jensen and William Meckling (1976), who integrated the principal–agent problem into a formal theory of the firm, posited two ways to reduce the agency costs created by the separation of ownership and control: first, effective monitoring methods implemented by the shareowners; and, second, altruistic bonding actions initiated by the agents (i.e., corporate boards and managers) themselves. Recently, Jensen (2009) asserts that ‘integrity’ is an important factor of production.

Bob Monks (2013) and others point to considerable evidence that today's monitoring methods by owners and bonding actions by agents continue to leave much to be desired and assert that, as a result, agency costs in the corporate sector continue to be material, as there is still a power imbalance to be redressed.

As early as 1936, John Maynard Keynes vividly described agency problems in the finance and investment sphere, observing that rather than turning savings into wealth-producing capital, professional investment managers seemed more interested in engaging in “beauty contest” investment games with each other. The object of these games was to guess which stocks average opinion would deem most attractive six months hence, be the first to buy such stocks now, and then be the first to sell them after average opinion has bid them up to higher prices in subsequent months. Keynes was not much kinder to investment committees, observing that their decisions usually reflected a herd mentality: “Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally” (Keynes 1936, 148).<sup>9</sup>

Several more recent writers have noted the dysfunctional “synergies” that can result from short-sighted interactions of finance and investment agents on one side, and their corporate business agent counterparts on the other. For example, Alfred Rappaport (2011) states the dysfunction potential case succinctly in *Saving Capitalism from Short-Termism*; Roger Martin (2011) has exposed it in the context of tying executive compensation to short-term share price changes; and David Blood and Al Gore (2011), Dominic Barton and Mark Wiseman (2014), and John Rogers (2014) have also written on this topic. Clear conclusions coming out of all these writings are (a) that agents continue too often to make business and investment decisions using criteria that favor their own short-term interests today, and (b) that principals (or fiduciaries acting on their behalf) must become more pro-active in fostering decisions that focus on longer-term value creation in their investments.

Research results confirm this “too often/too short” agency view. For example, on the commercial agent side, Graham, Harvey, and Rajgopal (2005) report that in a survey of 400 corporate executives, 78% would sacrifice long-term value to meet short-term disclosure targets. Burgman and Van Clieaf (2012) cite a survey by Equilar which found that only 7% of the S&P1500 companies had compensation plans that used four years or longer as the basis for calculating long-term performance. On the finance and investment agent side, Ron Bird and Jack Gray (2015) offer a sharp critique of investment managers pursuing their “beauty contest” games in “Principles, Principals, and Agents.” Data from Morningstar.com reveal that the average holding period for stocks in the 25 largest American mutual fund categories is now 1.4 years – which should not be surprising, given the CFA Institute's finding that in a sample of 1,100 portfolio managers and analysts, only 21% tied more than half of their performance-based compensation to longer-term performance measures (CFA Institute 2008). Similarly, my 2011 survey of 37 major pension funds found that only 8 (22%) used based performance-related compensation on measures over four years or more.

***Short-Termism, Human Foibles, and the Information Age***

Agency issues are not the only contributor to short-term bias in the modern world. The 24/7 barrage of information we experience is also a factor. As Nassim Taleb (2004, 61) has observed, “people do not realize the media are paid to get your attention. For a journalist, silence rarely surpasses any word.” To put it differently, in gathering and disseminating information, the media emit a great deal of noise but very little signal. In the realm of business and finance, the provision of quarterly earnings guidance offers a good example: while the long-term information content of a quarterly earnings announcement is effectively zero, such announcements provide fodder for the media and create buy / sell activity for the brokerage industry.

The relatively new field of behavioral finance helps explain this noise-driven activity. Loss aversion, availability and confirmation biases, anchoring, and herding behaviors all lead market participants toward short-termism and away from responsible long-termism.<sup>10</sup> A related but different perspective arises from distinguishing between rational expectations and rational beliefs. Mordecai Kurz (1994) notes that not all market participants interpret the pricing implications of new information in the same way. Model uncertainty and correlated mistakes are also important contributors to short-term market volatility. Jack Gray (2014) offers a third related perspective, noting that not everyone, even in the absence of agency conflicts, is temperamentally or cognitively adept at long-term thinking or behavior.

***From Agents to Fiduciaries***

These descriptions of the short-termism problem are also the first step toward solving it. A good start is to insist that the representatives of asset owners become true fiduciaries, legally required to act in the sole best interest of the people (e.g., shareholders, pension beneficiaries) to whom they owe a fiduciary duty. For example, legal expert Ed Waitzer and his collaborators have been developing the implications of this obligation in an increasingly complex world (see, e.g., Waitzer and Sarro 2013). The resulting message for the governing boards of pension and other long-horizon investment organizations (e.g., endowments) is that they must stretch out the time horizon in which they frame their duties, as well as recognizing the interconnected impact of their decisions on multiple constituents to whom they owe loyalty (e.g., not just current pension beneficiaries but also future ones). Increasingly, fiduciary behavior and decisions will be judged not by a cookie-cutter off-the-shelf “prudent person” standard by a much broader “reasonable expectations” standard.

A logical implication of these developments is that the individual and collective actions of the world’s leading pension funds are our best hope to transform investing into more functional, wealth-creating processes. Arguably, this is the investor class

with the strongest combination of motivation, legitimacy, competence, mandate, scale, and critical mass to become engaged in making responsible long-termism the foundation of their investment decisions.<sup>11</sup>

***The Deductive Case for Long-Termism***

So what conclusions can we draw from all this? Both deductive logic and the history of civilization support the premise that long-termism matters. Without it, we would still be societies of subsistence hunters and gatherers. It was wise foresight – that is, responsible long-termism – that led our forebears to save and invest part of their incomes so that they and their children could have a better tomorrow. Many centuries later, the question for us is whether those “better tomorrow” aspirations still have salience. If they do, then we will need to address the serious principal-agent challenges that the complexities of twenty-first-century civilization have thrust upon us.

Institutional investors around the globe, led by the pension fund sector, are well placed to play a “lead wagon” fiduciary role as we set out to address these challenges. Indeed, the emerging view is that pension sector leaders have a legal obligation to look beyond tomorrow, and to focus the capital at their disposal on the long term.<sup>12</sup> Will the effort be worth it? Logic and history tell us that the answer is “yes.” Qualitatively, long-termism naturally fosters good citizenship; quantitatively, a 2011 study that calculates the combined impact of plugging the upstream and downstream “leakages” in conventional investment decision making with a short-term focus found that the resulting shift to long-termism could be worth as much as 150 basis points (1.5%) per annum in increased investment returns (Ambachtsheer, Fuller, and Hindocha 2013).

***The Inductive Case for Long-Termism***

The *Oxford Dictionary of English* defines inductive logic as “the inference of a general law from particular circumstances.” The second part of this article sets out the “particular circumstances” of four extraordinary investor stories. Following the path of inductive logic, comparing these circumstances then leads to the common threads in the stories and to the “general law” that might be inferred from them.

***The John Maynard Keynes Story***

We have already met Keynes in the first part of this article. Quite apart from being the most influential economist of his day (and possibly of any day), Keynes also managed the endowment fund of King’s College at Cambridge University for 25 years (1921–1946), which gives us the opportunity to assess whether Keynes actually practiced what he preached as an investor. Was he a closet “beauty contest” investor? Or did he really invest for the long term?



Chambers and Dimson (2013) confirm that Keynes really did invest in line with his stated investment beliefs. He broke new ground in several ways: he was one of the first institutional investors to allocate most of his assets to stocks rather than bonds; he explicitly chose not to become a “beauty contest” trader himself, and instead invested in companies he felt had strong fundamentals and strong managements with dividend-paying cultures; and he was a high-conviction investor with concentrated positions that he held for a long time, rather than a closet indexer.

Over the 25-year period, Keynes earned an average annual return of 16.0% on the discretionary portion of the Endowment Fund, versus 10.4% and 7.1% for the British stock and bond markets respectively. His Sharpe Ratio ( $\{\text{portfolio return} - \text{risk-free rate}\} / \text{return standard deviation}$ ) was 0.73, versus 0.49 for the British stock market. Commenting on his success as an investor, he wrote in 1934,

*As time goes on, I get more and more convinced that the right method in investment is to put fairly large sums into enterprises which one thinks one knows something about and in the management of which one thoroughly believes. (quoted in Chambers and Dimson 2013, 223)*

In contrast, commenting on the poor prospects for success in short-term trading, he noted in a 1938 speech that

*Markets are governed by doubt rather than conviction, by fear more than forecast, by memories of last time and not by foreknowledge of next time. The level of stock prices does not mean that investors know, it means they do not know. Faced with the perplexities and uncertainties of the modern world, market values will fluctuate more widely than will seem reasonable in the light of after-events. (quoted in Chambers and Dimson 2013, 222)<sup>13</sup>*

### **From Keynes to Buffett**

In 1934, apparently unbeknownst to Keynes, Benjamin Graham and David Dodd of Columbia University published their canonical book *Security Analysis*. One of their most avid disciples was an investor named Warren Buffett. Following the investment strategies set out in *Security Analysis*, his firm, Berkshire Hathaway (BKH), would outperform the American stock market by 12.5% per year between 1976 and 2011. BKH's Sharpe Ratio was 0.76 (vs. 0.39 for the market), almost identical to Keynes's and #1 among the 140 American mutual funds and 598 stocks with a continuous 1976–2011 history (Frazzini, Kabiller, and Pederson 2013). A dollar invested in BKH in 1976 would be worth \$1,500 in 2011.

Frazzini et al. (2013) set out to discover the drivers of these off-the-charts results over a 35-year period. Was it skill or luck?

They found that they could come close to replicating BKH's results by consistently implementing the following strategy:

- Investment in a concentrated portfolio of companies with the combined characteristics of low beta / volatility; low price / book ratio; and high quality as defined by profitability, earnings growth and stability, and high dividend payout policy
- Long holding periods
- Increased preference for private over public companies over time (from 20/80 early on to 80/20 now)
- Modest, low-cost leverage through use of insurance company floats
- Aggressive tax planning (e.g., accelerated depreciation of assets)

Based on these findings, Frazzini et al. come down on the side of skill rather than luck: “BKH's results provides out-of-sample evidence that the G&D style of investing predicts returns and is consistent with the hypothesis of limited market efficiency” (2013, 3). They go on to point to Buffett's ability to stick to a successful strategy for a very long time despite a few patches of poor performance along the way, quoting Buffett's own words: “Ben Graham taught me 45 years ago that in investing, it is not necessary to do extraordinary things to get extraordinary results” (Frazzini et al. 2013, 5).<sup>14</sup>

### **Of Principles, Principals, and Agents**

If it is not necessary to do extraordinary things to achieve extraordinary investment results, why does this seem to be such a rare thing? I asserted in the first part of this article that the answer lies in understanding our modern-day principal-agent problem. Keynes was personally motivated by the goal of making Cambridge University a financially sound academic institution, and Buffett's personal fortune was riding on the success of BKH's investment program, meaning that in addition to having a sound grip on what kind of strategies it takes to produce extraordinary investment results over a very long time, Keynes and Buffett also had the personal motivation to implement those strategies.

Now think about today's massive network of finance / investment agents, positioned between people's accumulation of wealth (whether directly or through mutual, endowment, or pension funds) and the financial markets. Also think about the asymmetric information problem demonstrated so graphically by Akerlof (1970). Applying Akerlof's argument to the market for investment management services rather than used cars, I noted that if the sellers know more about the services they are selling than the buyers know about what they are buying, the buyers will pay too much for too little. If, aided and abetted by today's 24/7 media, finance / investment agents find it easier to convince investors that the best chance to grow their wealth is through picking winners in the short-term game of “beauty contest” investing, that is what most of them will sell.

All this raises a critical question: Can the investment beliefs, the long-horizon perspectives and behaviors, and the performance of extraordinary investors like Keynes and Buffett be institutionalized? After all, even these two extraordinary investors are mere mortals.<sup>15</sup> That is the question I address next.

### ***The Case of MFS Investment Management***

One of the headlines in the August 13, 1998, issue of *Business Week* read, “MFS MIT: A Fund That Epitomizes Long-Term Investing” (Stone 1998). The article noted that its 1924 start date made the Massachusetts Investment Trust, managed by Boston-based MFS Investment Management, the oldest mutual fund in the United States. It also noted that the fund’s long-term investment approach had produced a strong long-term rate of return. Fast-forwarding to today, MFS Investment Management is still a Boston-based investment manager, now with some \$400B under management, employing 1,700 people in offices around the world.<sup>16</sup>

A recent MFS paper titled “Lengthening the Investment Time Horizon” makes clear that MFS continues to think of itself as a long-term investor (Roberge, Flaherty, and Almeida 2013). Appropriately, the paper begins by quoting Keynes (1936):

*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. (quoted in Roberge et al. 2013, 1)*

Despite this wise advice, Roberge et al. (2013) note, the time horizons of institutional investment funds continue to shrink. For example, they point to data from **Morningstar.com** indicating that – driven by continuous media attention, the focus on quarterly earnings guidance, and the weight of short-term compensation incentives – the average investment holding period for the largest 25 American equity mutual fund categories is down to 1.4 years. MFS sees this as a “time horizon arbitrage opportunity” (Roberge et al. 2013, 2). As an example, the 10th percentile / 90th percentile excess return range for the stocks in the MSCI World Index was  $\pm 30\%$  for one-year periods; the cumulative five-year range was a much wider  $\pm 80\%$ . It follows that if most market participants are playing a one-year (or shorter) “beauty contest” game, the few that focus on a company’s ability to generate sustainable cash-flows in a five-year (or longer) time frame should have a consistent informational and opportunity advantage.<sup>17</sup>

How does this MFS hypothesis play out in practice? Roberge et al. (2013) report a 10.0% net return for the MFS Global Equity

Strategy from its inception on January 1, 1988, to March 31, 2014, versus a 7.4% return for the MSCI World Index over the same period. Regressing MFS monthly net returns against MSCI monthly returns produced an alpha (average monthly net excess return) of 0.25% and a modest beta of 0.90.<sup>18</sup> The fund’s Sharpe ratio was 0.46, versus 0.25 for the MSCI World Index, and it had 95 holdings on March 31, 2014, versus 1,610 holdings in the MSCI World Index. Portfolio turnover in 2013 was 10%, which implies an average investment holding period of 10 years. In short, there is a close relationship between the MFS hypothesis and the actual investment characteristics and results of the MFS Global Equity Strategy over the past 26 years.

### ***The Case of the Ontario Teachers’ Pension Plan***

The recently released 2013 Annual Report of the Ontario Teachers’ Pension Plan (OTPP 2013) reported that OTPP continues to have the highest 10-year net investment return in the CEM Benchmarking global pension fund database (consisting of some 300 funds) as well as the highest net excess return relative to its composite benchmark portfolio. Going back to its 1991 inception, OTPP has generated an average annual net return of 10.2%, versus 8.0% for its composite benchmark. Digging deeper reveals that the liability mismatch risk of the benchmark portfolio averaged 8.6%, versus 9.2% for the actual fund; this implies that OTPP generated an additional average annual 220bps (2.2%) of investment return by taking an additional 60bps (0.6%) of balance sheet mismatch risk, a ratio of almost 4:1. These additional returns have added CAD\$29 billion to OTPP’s balance sheet since 1991. Current assets stand at CAD\$139 billion.

How can we explain these extraordinary results? A starting point is OTPP’s stated investment beliefs, summarized from the 2013 Annual Report:

- ***Our responsibilities are intergenerational***, so we must be long-horizon investors.
- ***We take a holistic perspective***. Long-horizon investors must look beyond pure financial considerations and examine the environmental, social, and governance aspects of investing as well.
- ***We operate within a clear, integrated risk budget*** that includes liability mismatch risk, liquidity risk, and the use of derivatives to manage risk where appropriate.
- ***Our primary asset is human capital***. We empower our people, urge them to collaborate, and give them space to make mistakes.
- ***Investment markets are not fully efficient***; they offer exploitable opportunities to generate excess returns in both public and private markets.
- ***Strong global networks*** of people facilitate the identification and exploitation of investment opportunities.
- ***Investing is a business***; returns matter, but so do costs. (OTPP 2013, 18–23)

An important consequence of the belief that costs matter is that 80% of OTPP's assets are managed internally. Its strong in-sourcing strategies are especially effective in long-horizon private markets investing (e.g., real estate, infrastructure, private equity), where the "2-and-20" rule of thumb for fees can easily lead to total annual investment management costs in the range of 4%–5% of assets (see, e.g., Phalippou 2009; Dyck and Pomorski 2011).

Where did this unconventional set of investment beliefs come from? Its origins date all the way back to the only book management philosopher Peter Drucker wrote in a pension context (Drucker 1976), which he would later call his least read and most prescient work. One of its key messages was that effective pension institutions are not exempt from the principles that define any effective organization: mission clarity, alignment of interests between principals and agents, informed governance, strong executive function, appropriate scale, and competitiveness in the requisite labor markets. Assembling and managing this integrated package of aspirations and resources is an inherently long-term endeavor.

This message was central in the 1987 Rowan Task Force Report to the Ontario government on the future of public-sector pensions in the province, which advocated the creation of special arm's-length pension organizations based on the Drucker principles.<sup>19</sup> This recommendation was accepted by the provincial government of the day, as well as by the Ontario Teachers' Federation, and the result was the creation of OTPP in 1991. Claude Lamoureux was OTPP's first CEO; he retired 16 years later, in 2007, and the following year published his version of OTPP's unconventional inception and evolution (Lamoureux 2008).

### **Common Threads**

What are the common threads tied to success in these four stories? I see three:

1. **Articulating a clear stance and living it:** All four investors had a clear view of their investment goals and how they would to achieve them. Being out of step with the short-term mainstream was not only acceptable but actually seen as a competitive advantage.
2. **Investing in businesses:** Investing in businesses requires taking a longer view than is needed to trade securities in short-term "beauty contest" contexts. It also requires understanding business economics and strategy beyond their financial dimension.<sup>20</sup>
3. **Balancing conviction and humility:** This means accepting the reality that on the one hand, well-calculated risks must be taken to create long-term value, but on the other, shorter-term mistakes must, within reason, be tolerated.

Three further common threads run through the successful institutionalization of these three success drivers in the MFS and OTPP stories:<sup>21</sup>

1. **Autonomy to act:** The organization does not have to compromise its long-term strategies to serve multiple masters with short-term mindsets.
2. **Governance and management quality:** The organization's Board can ask the right, hard questions, and its senior executives have good answers to them; both groups are committed to creating long-term value for their beneficiaries / clients.
3. **Human capital:** Attracting and retaining people committed to executing long-term investment strategies is the organization's #1 success driver. This means thinking hard about selection processes, using long-term incentive structures, and creating a collaborative culture and working environment.

All simple to say, but hard to do. Especially for a very long time (see Ambachtsheer 2013).

### **The Case for Long-Termism**

The first part of this article developed a logical argument that long-termism is good for society and for those investors and corporations willing and able to practice it. The second part described four cases of remarkable long-term investment results that can be traced directly back to investors' willingness and ability to actually practice long-termism over extended periods.<sup>22</sup>

The case for long-termism is strong in both logic and outcomes. Embracing it is both an opportunity and a responsibility.

## Endnotes

- 1 This article has benefitted greatly from comments and suggestions by Jane Ambachtsheer, Rob Bauer, Lans Bovenberg, Colin Carlton, Jean Frijns, Jim Garland, Jack Gray, Anu Gurung, Roger Martin, Ranji Nagaswami, and Ed Waitzer. However, they are not responsible for any of the opinions set out here, nor for any errors or omissions.
- 2 The basic idea is that time preference affects the value of a dollar today versus a dollar tomorrow. A high time preference for a dollar today implies placing a high discount rate (i.e., a low value) on a dollar tomorrow.
- 3 There are some interesting cause-and-effect questions here. For example, do social changes lead to legal changes, or legal changes to social changes?
- 4 Bernstein's article is titled "The Paradox of Wealth." The paradox he points to is that "as [capital and] technology make the world ever wealthier, the returns on both riskless and risky assets will of necessity fall" (Bernstein 2013, 17).
- 5 Underdeveloped financial markets tend to produce small, undercapitalized firms, and very few large ones that can grow through retained earnings and by issuing new shares.
- 6 Arguably, Bernstein's reasons 2 and 3 are still works in progress, their potential contributions to taking civilization to a higher plateau not fully resolved. Indeed, focusing capital on the long term requires fit-for-purpose capital markets and clear, enforceable property rights.
- 7 A broad definition of commercial agents would include lawyers, compensation consultants, rating agencies, and so on.
- 8 Akerlof's celebrated article on asymmetric information and its consequences was "The Market for 'Lemons': Quality Uncertainty and the Market Mechanism" (Akerlof 1970). Ironically, it was twice rejected for publication as being of little significance.
- 9 This passage is found in chapter 12 of Keynes's *General Theory of Employment, Interest, and Money*, which may well be the best essay ever written on the confluence of investing and agency theory.
- 10 There is a budding literature in behavioral finance (see, e.g., Kahneman 2011).
- 11 Waitzer (2009) develops this argument. Thomas Piketty (2014) offers a broader context by providing estimates of the allocation of the current US\$350 trillion of global wealth between the top 1% (50%), the next 49% (50%), and the bottom 50% (negligible). In this context, the world's current US\$32 trillion in pension assets is largely "next 49%" wealth dedicated to financing the post-work phase of middle-class lives. The current US\$24 trillion in mutual fund assets is also largely "next 49%" wealth, but is far more subject to short-term agency factors, driven by asymmetric information, that operate in the global commercial finance and investments sector. Piketty's book raises profound questions about the growing economic power of the top 1%.
- 12 Prudential and financial markets regulation is not always as supportive as it could be in fostering long-term thinking and acting by corporations and investors. Regulators, too, need to embrace responsible long-termism in exercising their supervisory duties.
- 13 Keynes's words here foreshadow the writings of Shiller (2000) and Kurz (1994) on "rational expectations and beliefs," "irrational exuberance," and correlated mistakes by investors.
- 14 For more on Buffett, see his 19-page memo to *Washington Post* publisher Katharine Graham, posted on CNN.com in 2013 under the title "The 1975 Buffett Memo That Saved the WaPo Pension Plan." The memo is lucid, humorous, and wise. Buffett's final recommendation is to adopt an investment strategy "emphasizing a business approach to security selection," opining that this would enhance the pension fund's return without increasing its risk.
- 15 The April 26, 2014, issue of *The Economist* argues that with Warren Buffett now an 83 year-old senior, the time has come for him to start the orderly dismemberment of his US\$314B empire ("Life after Warren" 2014).
- 16 The firm did hit a regulatory bump on the road some 10 years ago, which was addressed at that time.
- 17 This concept of time horizon arbitrage is a central focus of Rappaport (2011).
- 18 The 0.25% monthly alpha has a statistically significant t-value of 3.3. Further statistical analysis indicated that the MFS portfolio had modest bias toward companies with smaller capitalization and higher growth (Roberge et al. 2013).
- 19 I became a principal advisor to the Rowan Task Force shortly after converting Drucker's principles into a how-to handbook for pension plan sponsors titled *Pension Funds and the Bottom Line* (Ambachtsheer 1986).
- 20 Note the contrast here with the new institutional investor frenzy about betas, which can apparently be "smart," "scientific," or even "exotic."
- 21 Note that for both MFS and OTPP, the long-term realized net excess returns were above 200 bps (2%) per annum area, higher than the hypothetical 150bps calculated in Ambachtsheer et al. (2013).
- 22 In a world of "big data," how can we justify using only four case studies to reach this conclusion? The nineteenth-century philosopher C.S. Peirce applied the term "abductive reasoning" to justify drawing plausible inferences from small samples for reasons of "simplicity and economy." In this case, arguably, the marginal value of the in-depth research required to construct additional detailed long-term investing case studies declines as the number of cases increases (as does the reader's attention span!). A good plausibility test might be this: "Q: Could these four long-term investing stories just be random draws out of a zero-excess-return investment universe? A: Possible but not likely." See McKaughan (2008) for more on Peirce and abductive reasoning.



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