

# IS SHORT-TERMISM A PROBLEM IN INVESTING AND, IF SO, WHAT SHOULD BE DONE ABOUT IT?

As far as the EU is concerned, the answer to the question “Is short-termism a problem” is yes. Its green paper, The EU Corporate Governance Framework<sup>1</sup>, refers to “inappropriate short-termism among investors” as if it were universally recognised as a fact. The UK’s Department for Business, Innovation and Skills (DBIS) has a similar assumption about the viewpoint of boards of directors. Witness question one in its consultation, A Long-Term Focus for Corporate Britain<sup>2</sup>: “Do UK boards have a long-term focus – if not, why not?”

1. EU Green Paper: “The EU corporate governance framework”, EU Commission 2011.
2. “A Long-Term Focus for Corporate Britain: A Call For Evidence”, UK Department for Business, Innovation and Skills, October 2010.



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**Main responsibilities**

Jane Fuller is co-director of the CSFI and also the director of Fuller Analysis, an independent consultancy.

**Experience and qualifications**

Jane spent more than 18 years on the Financial Times, culminating in the role of Financial Editor, and continues to train FT journalists. She is a member of Aviva’s Future Prosperity Panel and adviser to a start-up company in personal finance. Her longstanding interest in corporate reporting is pursued through the CFA Society of the UK, of which she is a fellow.

3. Fixed capital investment in China at 48 per cent of GDP compares with consumer spending at only 35 per cent.
4. For instance, see: Michael Ervolini, Cabot Research LLC, Behavioural Matters: Insights from the application of Behavioural Finance. Managing Emotional Capital. Issue 5, 23 July, 2008.
5. Andrew G Haldane "Patience and Finance". Oxford China Business Forum, Beijing. 2 September 2010.

The problem in addressing this issue is not limited, however, to the assumption among policymakers that short-term is bad and long-term is good. The definition of short-termism is so broad that it takes in judgments on directors' pay, mergers and acquisitions and "sustainability" (which itself stretches to environmental and social issues).

First a caveat. In this essay no blanket assumption is made that short-term is bad and long-term good. As Stanley Fink used to say, when chief executive of Man Group, the hedge fund manager, investment returns come in sprints as well as marathons. Just as short-sellers can be absolutely right – witness those hedge funds that made money from shorting sub-prime mortgage assets – long investors in industry may risk huge losses. China is often lauded by the long-termists, yet its fixed investment is so high that capital is bound to have been misallocated – and wasted<sup>3</sup>. "Buy low and sell high" is arguably a better investment guide than "buy and hold". Indeed, there is evidence from behavioural finance experts that investment managers neglect the discipline of objectively assessing when to sell and so miss opportunities to enhance returns<sup>4</sup>.

The argument here is that certain developments in capital markets have tilted the balance too far in the

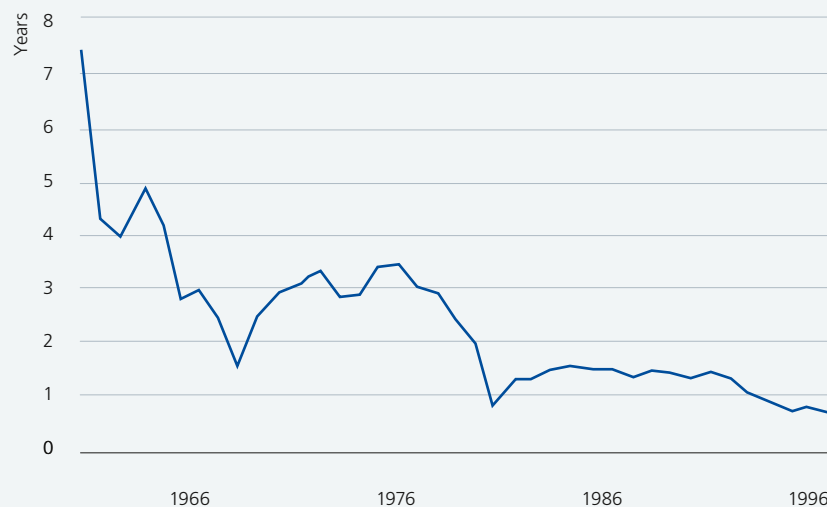
direction of "mindless" investment. As Aviva Investors says in its response to the DBIS consultation: "It is our view that the pendulum has swung too far towards the short-term and that the capital markets are not operating, in all cases, at optimal efficiency and effectiveness." Short-term trading strategies based on price movements, or momentum, are a prime example of this. But certain long-term investment approaches, such as index-tracking, might also lead to the misallocation of capital, since they neglect any attempt at objective valuation of the stocks being bought.

### Investment time horizons of shareholders

Andrew Haldane, executive director for financial stability at the Bank of England, has been one of the intellectual leaders in the UK in the anti-short-termism movement. In *Patience and Finance* (September 2010)<sup>5</sup> he charts a sharp decline in average holding periods for US and UK equities, from about seven years in the 1960s to about seven months by 2007. That for UK equities is depicted in Figure 1.

The apparent collapse in holding periods has been seized upon as evidence of "short-termism". This has, however, received a strong rebuttal from the Investment Management Association. Using recent data from Tabb Group, UK

**Figure 1. The average holding period for UK equities has declined**



Source: London Stock Exchange

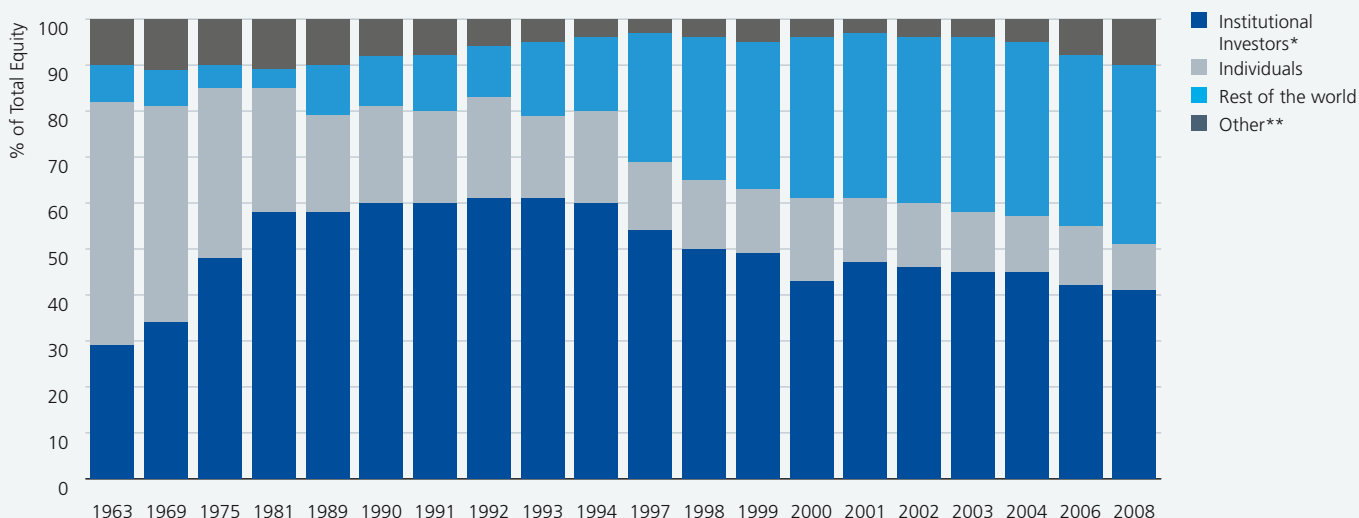
National Statistics and the London Stock Exchange, it argues that about two-thirds of the turnover in UK equities is accounted for by hedge funds and high frequency traders, with long-only funds responsible for 24 per cent. Since the last group manages the bulk of institutional money, its activity – or lack of it – is far more significant. For this group, average holding periods in the past decade varied from 29 to 46 months, with no discernible downward trend<sup>6</sup>.

Sitting on the sidelines does, of course, leave the field open to short-term traders, particularly potentially destabilising high frequency trading. If trading activity increases volatility, then the risk of an actively managed portfolio being out of synch with its market benchmark is increased. Since fund managers' performance tends to be measured against such benchmarks, the pressure to follow the herd, or closet index track, mounts. Indeed, fear of divergence from the benchmark has been ratcheted up since the end of the last century as memories linger of the legal action taken in 2001 by the Unilever pension fund against Mercury Asset Management, for negligence in diverging from its investment mandate.

Changes to defined benefit (DB) pensions accounting, which have exposed the mismatch between bond-like liabilities and volatile returns from an equity-heavy asset portfolio, have served to dramatically reduce long-term equity investment amongst DB schemes. Indeed, three savage stock market declines since the beginning of the millennium, coupled with seemingly perennial falling yields on the high-grade bonds used to calculate liabilities, have aggravated deficits and created pressure to reduce equity exposure. One outcome of the focus on asset/liability mismatches has been the rise of liability-driven investment, which seeks to provide greater certainty of outcomes, minimal risk of capital losses and less volatility in asset values. Meanwhile, the tightening of regulatory capital requirements for both banks and insurers has driven both to buy "high-quality liquid assets", such as government bonds. Then, of course, there's the tax system which continues to favour debt over equity. Indeed, as Aviva Investors' submission to DBIS says: "Currently the tax regime is formulated in a way that discourages the ownership of equity by investors and the financing of business by equity." Deterrents include stamp duty on share purchases and the unequal treatment of debt interest and dividend payouts.

6. See: "Investment Management Association Response to the EU Green Paper: The EU corporate governance framework." Annex 1, pp.8-9, 22 July 2011. Available at <http://www.investmentfunds.org.uk/commentary/05-08-2011>.

**Figure 2. Main share ownership categories in the UK, 1963-2008**



\*Institutional Investors include: Insurance companies, pension funds, unit trusts, investment trusts, other financial institutions.  
 \*\*Other includes share ownership other than Individuals, Rest of the world and Institutional Investors.  
 Source: National Statistics on share ownership

As a consequence of these regulatory changes and tax issues, the pendulum may well have swung too far towards investment in (safe, albeit longer-dated) debt instruments and away from long-term equity investment. Indeed, despite the massive increase in government bond issuance, fixed income instruments trade at or near historically low yields<sup>7</sup>.

**Implications for the short-termism debate**

Equities – too volatile to be “high quality” – are struggling against this competition for investors’ funds. However, fear of volatility, or myopic loss aversion, is overdone for savers/investors with long-term goals. Many people are interested in the current value of their houses, but they only need worry about it if they have to sell. They should have a similar attitude to long-term saving. So, those that represent them and manage their funds should be less worried about quarterly performance figures. This would reduce benchmark constraints, and may argue for longer-term mandates, or at least for longer-term views to permeate performance measurements.

Additionally, if the intention is to level the playing field between short-term traders and long-term investors, a number of public policy options exist. One option

is a capital gains tax that starts high and tapers to zero over a number of years. Another is a financial transaction tax, which is supported by the European Commission and Christine Lagarde, the new head of the IMF. If curtailing high frequency, momentum or speculative trading is the aim, then there are other ways to throw sand in the wheels.

This is already happening through the Basel III regulations, which impose greater capital requirements on trading activities; Dodd-Frank, which splits proprietary trading from other banking activities, curtailing the supply of capital; and legislation on both sides of the Atlantic that will push derivatives trading on to exchanges and through central clearing – again with additional capital requirements. Public policy makers now have excessive trading and “socially useless” financial innovation in their sights. But it is surely up to investors to ensure that their money is being applied to wealth creation, rather than employed by players in a zero-sum trading game.

**Responsible ownership**

Other concerns wrapped up in the short-termism debate include responsible ownership, as promoted in the Financial Reporting Council’s UK Stewardship Code

and a similar European Fund and Asset Management Association (EFAMA) code. The UK context is concerned about the falling proportion of the equity market owned by UK institutions. Figure 2 shows that this fell from close to 60 per cent in the 1980s to about 40 per cent in 2008. Within this, according to Office for National Statistics data, pension funds and insurers account for 26 per cent<sup>8</sup>.

Moreover, these institutions’ “buy-and-hold” strategies have increasingly been executed through index-tracking mandates, fuelled by a disillusionment with active fund management and a desire to reduce costs. The resulting cohort of “passive” investors is an obvious target for stewardship initiatives. If they cannot signal disapproval by selling the stock, they need to engage with the management to urge them to do better.

Similarly, investors ought to become more discriminating in approving large, top-of-the-market, leveraged bids, though this is not an argument against taking short-term opportunities to realise profits. For instance, fiduciary duty would still rightly lead an investor to accept Kraft’s high-premium bid for Cadbury.

7. In the UK alone, net gilt issuance rose from a negative number at the turn of the century to £211bn in 2009-10.  
 8. A Long-Term Focus for Corporate Britain: A Call For Evidence”, UK Department for Business, Innovation and Skills. October 2010.

However, while effective stewardship means monitoring investments and taking appropriate action – to buy, sell or lobby for change – applying judgment costs money, which must be paid for in fees either for active management or for governance efforts by passive managers.

### Conflicts of interest

One of the drawbacks of the short-termism debate is that it does not tackle conflicts of interest head on. Aviva Investors told the DBIS: “Conflicts of interest abound within the investment chain and these need to be properly managed.” The UK Stewardship Code is a start, but it will only work if all participants adhere to it. Transparency on fees is also important, including a breakdown of how clients’ fees are spent. This would provide evidence of any unnecessary “churning” of the portfolio.

But the issue here is not so much short-termism as the vested interests of different links in the investment chain and the opacity of costs.

### Conclusion

There are two main problems with the argument about short-termism. The first is that it is ill-defined and covers a long list of perceived problems. If the yardstick is maximising returns for investors, relative to the risk taken, then it is impossible to say that short-term decisions to take profits are bad, and long-term ones to commit money and wait are good. The problems that are most easily identified as short-term and in need of some redress are:

- excessive price-driven trading, which amplifies market upswings and downswings, increases volatility and creates intermediary costs
- mindless investing in market cap-based index trackers, or to match liability-driven benchmarks
- over-anxiety about short-term performance, and volatile prices, on the part of long-term investors, and
- regulatory and tax bias in favour of debt at the expense of equities.

Remedies include:


- throwing grit in the wheels of trading activities that are either zero-sum games (winners and losers cancel each other out), or risk occasional catastrophic losses that destabilise the financial system. This is happening via Basel III, Dodd-Frank and other reforms. Taxation may be an additional tool
- encouraging “thinking” investment by loosening fund manager benchmark constraints, using more sophisticated benchmarks, and ensuring that longer-term investment goals are captured in performance evaluation
- encouraging passive investors to monitor companies rigorously in the context of long-term wealth creation. This is what stewardship codes are trying to achieve
- where investment goals are long-term, considering asset and liability measurement techniques that allow for a higher risk appetite and lower sensitivity to volatile prices than conventional measurement methods, and
- levelling the tax and regulatory playing field between equity and debt.

“Conflicts of interest abound within the investment chain and these need to be properly managed.”

Aviva Investors



### Key points

- “Short-termism” is ill-defined, covering everything from high-frequency trading to stewardship of companies. It is too simplistic to say that the long-term view is always good and the short-term one bad.
  - The problem is more one of “mindless” investing, based on price momentum or index-tracking.
  - If investors have a long time horizon, then they should be less worried about volatility and short-term divergence from market-cap-weighted benchmarks; this argues for loosening benchmark constraints, for more sophisticated benchmarks and for more “thinking” investment.
  - The amplification effects of high-frequency trading and momentum trading can, and are, being tackled by new regulation on both capital backing and derivatives trading.
  - To help level the playing field between equity and debt, assumptions about risk appetites should be questioned, and regulatory and tax biases need to be confronted.
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