ADDING VALUE

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SUMMARY:

In this issue of Adding Value, we examine the cause and effect of short- term thinking for corporations, investment firms and investors. The practices are insidious and deleterious to our financial well-being. The marketing strategies utilize deeply-rooted cognitive biases that are in the final analysis harmful to investors. We all need to examine more deeply what short-term numbers mean to our financial health.

ADDING VALUE is mailed quarterly to our clients and friends. The intent of this publication is to share some of our more interesting views and research with our clients.

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Third Quarter Investment Review and Outlook

Short-Term Thinking

In this newsletter, we will consider the effects of short-term thinking on corporations, investment managers, and investors. Ideas for this newsletter were generated from the conferences that we attended in the Spring and most notably the opening address from the Morningstar conference by Michael Mauboussin, Chief Investment Strategist at Legg Mason Capital Management. His topic was “Long-Term Investing in a Short-Term World.”

Corporations

In the corporate world, CEO compensation has changed dramatically over the past 20 years. In 1986, an Internal Revenue Service ruling stated that any corporate manager compensation above $1 million could only be tax deductible for a corporation, **if** it was related to some sort of incentive. Corporations usually react swiftly to IRS-based incentives and this ruling was no exception. In this case, companies decided to tie more executive compensation to stock price performance (mainly through the use of stock options). To see how fast the ripple effect occurred one should note that, in 1985, only about 1% of CEO compensation was tied to the stock market. By 1995, 43% of executive compensation was tied to the stock market. Today, about 60% is tied to the market. The original laudable intention of the ruling was to align the interests of corporate management with the shareholder-owners. At least in theory, long-term value creation should benefit both management and shareholders. However, management believed that the way to get stock prices up was to focus on quarterly earnings growth, rather than long-term value creation. Long-term value creation, a more difficult concept to explain, concerns generating returns above the corporation’s cost of capital and may have little to do with short-term earnings growth. In fact, it can involve making decisions that could lower short-term earnings when the outcome of the decision is years away.

CEO COMPENSATION	
1985	1% of Compensation Tied to Market
1995	43% of Compensation Tied to Market
2005	60% of Compensation Tied to Market

Source: Brian J. Hall and Jeffrey B. Liebman, “Are CEOs Really Paid Like Bureaucrats?” NBER Working Paper 6213, October 1997; “2004 CEO Compensation Survey and Trends”, Wall Street Journal/Mercer Human Resource Consulting, May 2005; LMCM estimates.

So why have corporate decisions evolved into an obsession with earnings? The answer was found in a survey of over 400 corporate executives. The majority of executives view earnings as the key metric for an external audience which has gradually been internalized into the corporate structure. As one executive was quoted: "Earnings are in a class by themselves." The survey arrived at four reasons for the focus on earnings.

1. Investors need a simple, uncomplicated metric to summarize performance.
2. Earnings-per-share get the broadest media distribution and coverage.
3. Focus on earnings-per-share makes the Wall Street analyst's job easier.
4. Analysts evaluate a firm's progress based on making earnings forecasts.

This illustrates the first barrier to long-term thinking which psychologists call the ***availability bias***. The availability bias implies that information that is easily available (i.e. earnings) tends to get over-weighted compared to information that's relevant (i.e. long-term value creation). Even more striking is the finding that 80% of the firms surveyed were willing to sacrifice long-term value creation in order to meet a short-run earnings target. The preference for earnings is so strong that 78% of the surveyed executives indicated that they would give up economic value in exchange for smooth earnings. Examples abound from interviews with executives of real decisions by management to manage earnings including 1) eliminating or postponing research and development spending; 2) eliminating maintenance spending to meet earnings targets, even if such deferment would accelerate the need to replace the asset in the future; 3) delaying the funding of pension plans; 4) pretending that stock options are not current expenses; or 5) other more creative ways to reduce expenses. The main point is that corporations are not making optimal economic decisions because of the system we have today. Corporations are too focused on earnings and not on value creation. The innocuous shift in 1986 to reform and hold management accountable for compensation over $1 million by tying compensation to stock price performance seems to have had unintended consequences. One simplistic way to examine this phenomenon is to look at your own savings accounts. Just quadruple the capital you commit and you will quadruple your earnings. Although it would be good news to save more, you can hardly expect hosannas for increasing your earnings by simply investing more. Similarly, corporate announcements regularly sing the praises of CEO's who have for instance quadrupled earnings at the company during their reign and paid themselves handsomely (maybe obscenely) for the feat – with no one examining whether this gain was attributable simply to many years of retained earnings and the workings of compound interest. After all, a savings account in which interest was reinvested would achieve the same year-by-year increase in earnings, and at an interest rate of 8% would quadruple its earnings in 18 years, without any management action.

Investment Management

John Bogle, founder and former Chairman, The Vanguard Group, was quoted in the Wall Street Journal on October 3, 2005: "The amazing disappearance of the individual stockholder as the backbone of the U. S. stock market has been one of the least recognized but most profound trends of the last half-century." In 1950, individual investors controlled about 91% of the direct stock holdings of the U. S. market. By 1970, individuals still controlled about 67%, but a substantial decline in twenty years. As recently as 2004, individual ownership declined to 32%, implying that financial institutions control 68% of stock ownership. So although individual investors remain major participants in the stock market, they do so now largely through a financial intermediary.

As with the 1986 IRS change in the corporate world, the change from private ownership to public ownership depended on a single landmark case that in hindsight had profound implications for the individual investor. In 1956, the owners of Insurance Securities Inc. sold their ownership to a new purchasing group. The Se-

curities Exchange Commission argued at the time that the sale of a fiduciary office was a “gross abuse of trust” under the Section 36 of the 1940 Act.

The SEC lost the case and the floodgates opened. By the mid-1960’s, a score of fund managers had become publicly held, including industry leaders like Dreyfus and Putnam. But public ownership was just the beginning. Over the following decades another mutation occurred, ownership of the industry’s major management firms was acquired by giant financial conglomerates, largely U.S. and international bank holding companies that included Bank of America, JPMorgan Chase, Deutsche Bank, AXA, and UBS. Further, major investment bank and brokerage firms also entered the field of fund management like Merrill Lynch, Morgan Stanley, and Goldman Sachs. Nobel Laureate Paul Samuelson in a 1971 speech said: “All things considered, it is undesirable for professional enterprises to have public shareholders. This constraint is as applicable to money managers as it is to doctors, or lawyers, or accountants.” As with any public company described in the first section of this newsletter, investment management, by being run by a large conglomerate, is subject to the same earnings pressures as large corporations. Indeed it is possible to envision circumstances in which pressure for earnings and earnings growth engendered by public ownership is antithetical to the responsible operation of a professional investment organization. That is why it is critical to seek out an investment manager that has an alignment of interest to the investor. Otherwise, financial agents may have their own interests (higher earnings per share through higher fees and more products), that conflict with the interests of the owners (lower fees, size limitations on assets under management, and fewer products).

When viewed as a profession, the intention of management is to deliver superior long-term results. This requires an attitude of patience and a contrarian approach. On the other hand, a business-focused firm is seeking a return for the company, not necessarily their investors, by focusing on generating sales and gathering assets.

Consider a study done by Fidelity Investments of mutual fund firms comparing the number of funds each firm has in the market place with their relative returns. Fifteen funds were chosen as a dividing line between firms that are focused versus firms that are marketing driven. The study showed that the funds of the focused firms had significantly better long-term performance compared with the funds of the marketing-driven firms. Similarly, Fidelity also examined in a second study the ownership structure of the mutual fund firm versus the relative returns of the fund family. The vast majority of the privately owned firms’ funds outperformed the funds of the publicly owned firms. It appears that in the public owned firms, business comes first. In the privately owned firms, investment performance comes first. The main point is that the optimal balance between the investment profession and the investment business needs always to favor the profession.
In the portfolios that we construct for our clients, we have representation in eight of the top ten privately owned firms. This decision was made a long time before the statistical evidence was compiled to favor the private investment firm.

Investors

Short-term thinking among individual investors can be condensed into one sentence. Individuals chase what has been hot. Study after study illustrates bad timing by individuals. Consider a recent report:

AVERAGE ANNUAL RETURN (1983-2003)	
S&P 500 Index Fund	12.8%
Average Fund Return	10.0%
Average Investor Return	6.3%

The above table shows that the average equity mutual fund investor’s return of 6.3% fell be-

hind the index fund by a total of 6.5 percentage points a year, or less than one-half the stock market's annual return. The average fund lagged the market by 2.8 percentage points per year. Most of the difference can be traced to the increasing cost investors pay for management fees, fund expenses, and the ever-increasing turnover (buying and selling of individual securities within the fund). The average investor return of 6.3% and the average fund return of 10.0% represent the penalty investors paid for counterproductive timing of their purchases and sales. As the fund industry increasingly focused on marketing, investors were deluged with an array of "hot" new funds that specialized in the current market fads. Internet funds, new economy funds, and other specialized and usually speculative products were created and promoted. Investors poured money into these funds at an unprecedented rate and at the same time exited funds that weren't "hot," all at the wrong time. This is a classic case of buying high and selling low. One can view this as a cost of short-term thinking. This behavior is not unique to the 1983-2003 measurement period. Why do investors make this mistake? Psychology provides a likely explanation called the ***recency bias***, which says individuals tend to extrapolate recent outcomes (what's hot), without giving full weight to the full time series or prevailing circumstances. As Bill Miller of Legg Mason Capital Management noted, "People want to buy today what they should have bought 5 or 6 years ago; call it the 5 year psychological cycle."

Conclusions

The overwhelming evidence demonstrates that short-term thinking and some incentive structures result in sub-optimal decisions by corporate executives, investment managers and individual investors. There is a significant cost to this short-termism. Psychology and incentives explain much of this poor behavior. A recent Chartered Financial Analyst Symposium on the subject recommended the following:

1. Reform corporate earnings guidance practices.
2. Develop long-term incentives for corporate executives and asset managers.
3. Demonstrate leadership in shifting the focus to long-term value creation.
4. Promote broad education to all market participants about the benefits of long-term thinking and the costs of short-term thinking.

It might be prudent to come up with snazzier words to reform current practices, but the fact remains that short-term thinking is ingrained in our business models and in the teaching of our students by business schools. It is to everyone's benefit that we understand what influences our thinking and make a determined effort to stop bad practices now.

Sincerely,

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