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Criticism of short-term investing grows after Woodford departure

By Alison Smith and Stephen Foley

It has been an uncomfortable few days for short-termism. [Neil Woodford's decision to quit](#) Invesco Perpetual gave fresh prominence to the leading fund manager's longstanding complaints about investing for the short term. Then a much less familiar critic – Prince Charles – weighed in, saying that the “current focus on quarterly capitalism is unfit for purpose”.

The issue is not confined to the UK. In the US, organisations such as the CTA Institute and the Aspen Institute have in recent years pulled together coalitions of investors and business leaders as august as John Bogle of Vanguard and Warren Buffett to bemoan short-termism and to proffer potential solutions.

Quantifying the growth in short-termism is tricky, though the average duration of equity holdings is sometimes used. From 1940 until the mid-1960s this was around seven years in the US. By 2007 it had fallen as low as seven months, though it has since crept up again and now stands at almost two years.

But this average cannot capture the fact that many companies have two speeds: a large proportion of the share register remains stable for some years, while the remainder changes quickly. The London Stock Exchange points out that data from 2011 show 83 per cent of investors turned over their portfolio less than once every two years.

Moreover, some critics argue that short-termism is not even about the holding period. Paul Woolley, senior fellow at the London School of Economics, defines it as following trends to make money or reduce risk. “Short-termism is an investment strategy based on responding to price change rather than fundamental value.”

However defined or measured, there is no doubt that short-term activity has increased. One reason is lower transaction costs. Rhodri Preece, director of capital markets policy at the CFA Institute, says: “Electronic trading developments have improved operational efficiency and narrowed spreads, reducing the indirect costs, while fees from competing exchanges have come down as well”.

The sheer amount of available data also encourages the short view. Fund managers complain that the information overload of the internet era puts pressure on them to react to short-term “noise” about their portfolio stocks and encourages their investors to second-guess their managers, too.

Regulation has also played a part, according to Prof Woolley. “Though the OECD and the EU bemoan the short-termism of the markets, they contribute

to it through the 'mark to market' regime imposed by the regulators. That regime means you have to reduce your downside risk by short-term hedging." But the key to increased long-termism is the relationship between managers and the investors whose funds they look after.

According to John Kay, who carried out [a review of UK equity markets](#) last year: "The short-term horizon is basically introduced by the intermediary sector."

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Michael Roberge, chief investment officer at Boston-based MFS Investment Management, which launched the first mutual fund in 1924, says that across the industry, managers' pay is still overwhelmingly based on one-year performance. This leads them to churn portfolios in the hope of beating their benchmarks towards the end of the year.

So a shift away from short-termism requires a contract between manager and investor that is not just about benchmarks and targets, even though this requires the investor to give the manager more freedom. "The onus is on pension funds to insist on contracts that cover investment strategies," says Prof Woolley.

Investors keen to promote long-term strategies must also accept that their fund managers will have periods of poor returns.

Even a manager with [Mr Woodford's stellar record](#) has sometimes lagged behind the market – in 1999 by 14 percentage points, and in 2009 by 23 percentage points.

The late Tony Dye at UK fund manager PDFM had many years of success as a value investor. But his refusal to buy dotcoms led to a string of client departures in the late 1990s, and he was fired in 2000 just before his strategy began to pay off.

Eric Upin, chief investment officer at California-based Makena Capital Management, selects portfolio managers that can focus on the long-term horizon, but says they are getting harder to find, partly because of pressure from pension funds, which must justify their use of a manager to their own board of trustees.

"If you are reporting to a committee it is very hard to justify staying the course when several quarters go by when they are seeing underperformance," Mr Upin says.

Mr Woodford's past successes mean that raising money for his new venture should be straightforward. But imagine the hurdles in the way of a manager who would like to pursue long-term strategies but is just starting out. As Prof Kay puts it: "How easy would Warren Buffett find it to set up now?"