Being BAEP

A long story told short

March 2016

Equities are, by their nature, long term investments. Nevertheless, investors have become very short term sighted in their consideration of equities, focusing on the daily market noise and often flipping to and fro in their quest for quick returns. In this edition of *Being BAEP*, we consider the 'short-termism' that prevails in the business and investment worlds, and the risks and opportunities that this presents.

Warren Buffett wrote in his 2014 Berkshire Hathaway letter to shareholders:

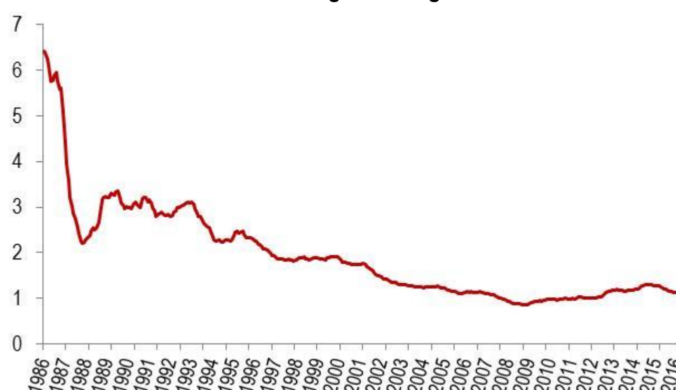
> *"Games are won by players who focus on the playing field - not by those whose eyes are glued to the scoreboard. If you can enjoy Saturdays and Sundays without looking at stock prices, give it a try on weekdays."*

I wonder sometimes why newspapers still dedicate considerable space setting out all those stock prices, and who in fact relies on them? Nowadays, real time quotes and the 24/7 news cycle keep investors up-to-date. Most will claim they invest in equities for the long term, which of course they realise comes across as the sensible course. Most, however, can't help but be tempted by it all. My Uncle Dave, a well-enough-to-do retiree, recently admitted he checks in on his stock portfolio about four times a day. Human nature is such that we are overly focused on the here and now.

Share 'holders'

Equities are the quintessential long term investment. While returns are generally superior to most other asset classes, they can be quite volatile in the short term, but are far more reliable the further out one looks. Thus, reflecting this, the typical asset allocation recommended for investors comprises a declining equities exposure as they age and their orientation shortens. To invest in equities is to become a part owner of businesses with lifetimes often longer than our own. For perspective, consider that ASX-listed AGL started out in 1837, Wesfarmers in 1914, and CSL in 1916.

Despite this, investors in the Australian share market have increasingly become short sighted. This 'short-termism' manifests most obviously in the frequency of our trading. Three decades ago, the average holding period for Australian shares was more than six years. This has now declined to just one year[1]. We no longer own equities, we rent them. In aggregate, investors can only suffer from this increased activity, owing to the additional costs of trading and taxes. These additional costs can be considerable.



Professional short-termism

It is not just retail investors at fault. It turns out that professional investors are just as human, and they too yield to the same temptations. Regardless of their often considerable training and experience, it is hard to brush aside thousands of years of human evolution, and our psychological instinct to give undue emphasis to short term outcomes.

In fact, owing to the pressures that result from clients' close scrutiny, short-termism can be even worse for professional investors. Fund managers are required to report their performance on a monthly basis, a timeframe that most would agree is at odds with the long term nature of equities. The unfortunate reality is that many clients, including both retail and institutional clients, very often look to short-term performance in determining whether to invest in a fund. Significant short-term underperformance comes with the risk of losing clients, a risk that forces many fund managers to become overly focussed on short-term results. They get lost in the daily noise of the markets and find it difficult to look out much further than the next earnings result. The risk of client loss also forces many fund managers to become risk averse. Standing out to make a difference comes with the real risk that you fail miserably and, worse still, that you do so alone. In their attempt to avoid this, many fund managers will hug the index closely, with very similar portfolios that are designed more to avoid failure than to add value with meaningful outperformance.

[1] IRESS, Deutsche Bank, BAEP. Average holding period calculated as the inverse of the rolling 12 month velocity of the All Ordinaries to 31 January 2016.

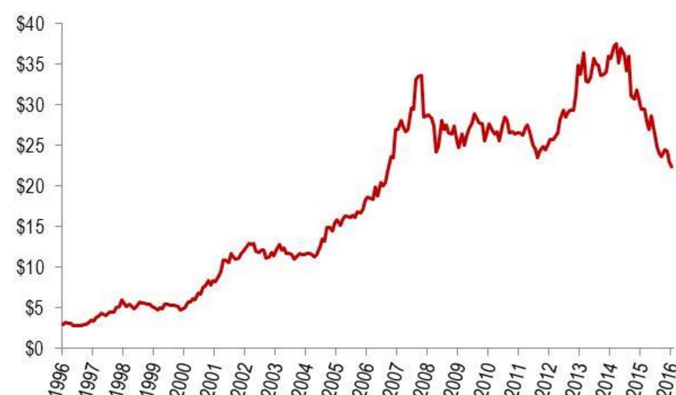
Corporate short-termism

Investors' short-termism can also permeate down to the corporates themselves. Corporates feel significant investor pressure to deliver on short-term expectations and to avoid risk that might jeopardise doing so. This is reinforced by the deliver-or-go mentality that has recently taken scalps like Grant O'Brien at **Woolworths** and David Knox at **Santos**. To the extent that CEOs have long-term incentives, the performance period over which they are determined is typically just three or four years, a time period too short to see through the full lifecycle of corporate planning. Worse still, the performance that generally matters most for these incentives is the relative returns of the company's shares, thereby encouraging decisions that align with what the market might perceive is best rather than what actually is best for the long term. Incentives matter, and in the case of a CEO's incentives, they are predominantly short term orientated.

Thus, for example, a CEO might choose to avoid or put off investment in research projects, product development, staff training or other long-term projects that come with additional costs today but could add material value further down the track. These CEOs then fall into the same myopic and low-risk strategy that many professional investors fall foul of.

Woolworths provides a classic example of short-termism gone wrong. For some time, Woolworths had enjoyed a considerable scale advantage over its competitors, with its larger sales base giving it far more margin to play with. Woolworths invested some of this margin advantage into lower shelf prices and better service, which in turn attracted more custom and even greater market share. This further bolstered its scale advantage and gave it even more margin with which to invest back in its customer offering. The 'virtuous circle' ensured it sustained its scale advantage and underpinned quite decent long-term sales and profit growth. However, about a decade ago, the CEO's baton passed from Roger Corbett to Michael Luscombe, and the company changed tact. Increasingly, the company invested less of its margin advantage back into its customer offering, retaining more of the margin for itself. This change in strategy helped to push up profits, which investors rewarded with a higher share price. However, it also came at the expense of diminishing reinvestment, which gradually ate away at the relative attraction of its customer offer. This ultimately opened the door for Aldi and a rejuvenated Coles, both of which started to grow sales faster than Woolworths. Eventually, they were able to break down Woolworths' market dominance. Mid-last year, the then CEO, Grant O'Brien, admitted that Woolworths had put profits ahead of its customers. ASX-listed CEOs, whose average tenure is approximately five years, tend not to be rewarded for what they build and leave for their successors. This was how it was for Grant O'Brien, and how it is for the new CEO, Brad Banducci, who started recently, and who now faces a difficult turnaround that the Chairman is saying will take three to five years. Meanwhile, the share price has come back to where it was around the time of the baton change from Corbett to Luscombe approximately 10 years ago.

Woolworths Share Price[2]



Dividends over reinvestment

In February this year, Blackrock's CEO Larry Fink wrote a letter to the CEOs of all S&P 500 and large European companies. For context, Blackrock is the world's largest asset manager, with almost US$5 trillion under management, and it is often a major investor in these companies. In the letter, he noted how many CEOs had talked-the-talk in their fight against short-termism, but that corporate behaviour evidenced they had yet to walk-the-walk. Chief among his concerns were corporates prioritising dividends over investing for growth.

In Australia, as elsewhere, boards have acquiesced to the desires of shareholders to maximise dividends. This calendar year, ASX-listed companies are expected to pay out dividends representing an average of 75% of earnings[3]. Once you add in buy-backs, these companies will be returning to shareholders approximately 85% of their earnings. This is up at multi-decade highs, well above an average of approximately 50% in the 1980s, and obviously leaves very little for investment.

[2] Source: IRESS

[3] Source: Credit Suisse, BAEP data. Figures quoted are average for companies that make up the All Ordinaries.

Interestingly, while the corporate form was originally designed as a conduit for new investment, cash now flows the other way.

The ability for companies to reinvest and thereby grow makes equities quite a unique asset class. It is in fact one of the main attributes that allows equities to offer investors capital growth. Reinvestment can add to earnings and create shareholder value. While the benefit of this is not as transparent as a dividend cheque, the value accretion should ultimately come to be reflected in a higher share price. Indeed, to the extent that it is executed at attractive returns, reinvestment will add more to the value of a company's shares than the amount that would have otherwise been paid as a dividend[4]. Thus, for companies like **Ramsay Health Care** that can reinvest at rates of return of 15% or more, it makes sense for shareholders to prefer retention and reinvestment over dividends. Despite this, investors have generally pushed for the dividends, presumably figuring that one in the hand is worth more than two in the bush.

As highlighted recently by the RBA and others, prioritising dividends over investment has broader economic implications. In Australia, as in most developed countries, a lack of corporate investment has been given as a reason for the insipid economic growth. Corporates are apparently too generous with dividends and are left with little to spend on new plant and equipment, hiring and training, and research and development[5]. Hilary Clinton has even picked up the issue in her run for the White House, attacking 'quarterly capitalism' and proposing tax and other reforms that discourage "a culture of short-term speculation" and encourage corporate investment.

The RBA has a point. For example, research and development spending as a percentage of Australia's GDP rose each year from 2000 to 2009, peaking at 1.37%; it has fallen each year since, and sat at 1.19% when last reported for 2014. Evidence elsewhere supports a lack of corporate investment. To be fair, most corporates, whether in Australia or elsewhere, have a growth problem. It is partly because of the insipid economic growth that corporates are failing to invest, not just vice versa. Demand is broadly weak, and an increasing number of industries face new disruptive challenges that create uncertainty. As well, many industries face overcapacity, such that expansion makes little sense until demand grows and capacity utilisation rises. The upshot is that few companies have the confidence and in fact the opportunity to reinvest. Instead, they have found it far easier to simply hand monies back to shareholders.

A balanced approach

> *"The manager's job is to keep his nose to the grindstone while lifting his eyes to the hills."*
>
> *Peter Drucker, respected management consultant & author*

Not all short-termism is irrational or bad; only where the focus on short-term performance comes at the expense of long-term value creation. Short-termism can in fact make sense for example for a company that is financially on its knees and fighting for survival. Likewise, not all long-termism is rational or good. For example, it does not make sense for a company to add capacity in an oversupplied industry or undertake highly speculative projects or ill-considered long-term investments. Woolworths' large-scale investment in the Masters home improvement start-up is a case in point, where literally billions invested in the venture are about to be lost. It all comes down to a balancing act between the short term and the long term, and as Jack Welch of General Electric fame once said, "balancing those two things is what management is". After all, corporates must invest in their future if they are to have one, but must also produce earnings today in order to be able to do so.

Earning the right to take the long-term view

As Larry Fink advised in his letter to large company CEOs, to the extent that CEOs need to sacrifice the short term for a more valuable long term, it is incumbent on them to communicate and educate investors on their strategy for doing so. Long gone are the days of 'managerial capitalism' where boards and management operated autonomously. Investors have greater say in the running of companies these days – witness IAG backtracking on its expansion into Asia due to shareholder pressure - and CEOs need to bring them along for the journey. Those that do can earn their company the right to sacrifice short-term profits, and to retain and reinvest funds for the long term.

The following are a few of the limited number of examples in the Australian context:

- **CSL** is spending almost US$500 million annually on research and development into identifying new biopharmaceutical and other medicines, developing markets and improvements to existing

[4] "Attractive", in this context, means returns above the company's cost of capital.

[5] Source: ABS data

products. It has also recently acquired a flu vaccination business that will hurt profits in the short term, but that if successfully turned around, will add significant value over the next five years and beyond.

- The **Star Entertainment Group** is currently spending approximately $300 million refreshing its Gold Coast hotel and casino, and is part of the joint venture that will soon start on the $3 billion Queens Wharf casino complex in Brisbane.
- **Ramsay Health Care** spent $190 million in hospital expansions in Australia last financial year – investing also in more doctors, nurses and other staff – and it also has plans to spend another $1 billion over the next five years on similar developments.

While most company CEOs often bemoan investor short-termism, companies like these attract those investors with a longer term view.

Finding value beyond a short-term horizon

Fortunately for us at BAEP, there are very few other investors willing to take the long-term view. Short-termism is engrained within investor psychology and this presents us with opportunity. While investors are focused on the short term, we look further afield and find value that is not yet within investors' sights.

In our view, the Australian share market is systemically short sighted. Its value bias means that it is very often overly focused on PE multiples and dividend yields that rely on just the next year's estimate of earnings or dividends. Ordinarily, either of these will account for less than 10% of a company's total valuation. This market's focus on the short term can very often undervalue earnings that are reliable and growing strongly over time, where compounding is left to work its magic. To take an example, a company that grows earnings by 19% per annum for four years, which is at a level that **Ramsay Health Care** has achieved over the past decade, will have doubled its earnings and halved its starting PE multiple. The value beyond just next year can be considerable.

Conclusion

At BAEP, we invest with our nose to the grindstone and our eyes raised to the hills.

We seek to buy and hold high quality and strongly growing companies, the type that create considerable shareholder value from investing for the long term. For example, we have owned a company like **Ramsay Health Care** throughout this decade, during which we have quintupled our initial investment. We hope to hold it for a long time yet. However, we are cognisant that things can change: growth profiles mature, a new CEO may not be up to the challenge, the company makes a questionable acquisition, regulation changes for the worse, or investors' expectations get ahead of themselves. Indeed, there are increasingly signs that change is accelerating in the corporate world. In these instances, when the facts change and a company's fundamentals deteriorate, we will find other great companies in which to invest.

Fundamentally, investment is about giving up current consumption for potentially greater consumption in the future. Within this context, and by their very nature, equities represent a form of investment that provides for retirement and other long term goals. Focusing on the constant noise of real-time quotes and never ending news flow is to forget about the goals most use equities to achieve.

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BAEP

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