The 10 Essential Elements of Investing

Essential Element 7
Use time

Beaver Investing

The investment guide for Canadian foundations and charities
Third edition

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Let's consider the advantages that charitable investors do not have over other investors. Unlike pension plans or sovereign wealth funds, most do not invest billions of dollars; unlike hedge funds, they do not have PhDs in theoretical astrophysics to design the latest investment algorithm; and unlike publicly-traded companies, they do not enjoy inside information. They possess only two functional advantages over other investors: they are tax-exempt and they have the potential to invest for the long term. The first, although important, is common to all charitable investors. The second can vary a great deal. To start, we will show that the role of time permeates all other investment planning decisions, including setting the asset mix, diversifying, simplifying, balancing risk and controlling cost (reprising the themes of Essential Elements 2-6). We will then discuss how industry and institutional incentives can prevent foundations and charities from making the most of a long time horizon.

The role of time

In Essential Element 2: Set the mix, we showed that as the investment holding period becomes longer, it becomes increasingly likely that stocks will outperform bonds and bills (Treasury bills, equivalent to cash).[1]

Table 1: Percentage of time stocks outperform bonds and bills over various holding periods, United States, 1871 to 2012

Holding period	Stocks outperform bonds	Stocks outperform bills
1 year	61.3%	66.9%
5 years	69.0%	74.6%
10 years	78.2%	83.8%
20 years	95.8%	99.3%
30 years	99.3%	100%

This underlines the importance of a healthy allocation to stocks, given the historical long-term advantage of stocks over bonds and bills. Below we present the long-term real returns for stocks, bonds and bills for the United States from 1802 to 2012, applied to an initial balance of $10 million over periods of 10, 20 and 30 years.[2]

Table 2: Return differential of stocks over bonds and bills, real terms

Asset class	After 10 years	After 20 years	After 30 years
Stocks: 6.6%	$18.9 million	$35.9 million	$68.0 million
Bonds: 3.6%	$14.2 million	$20.3 million	$28.9 million
Bills: 2.7%	$13.1 million	$17.0 million	$22.2 million

In Essential Element 3: Diversify, we mentioned the importance of diversifying stocks across the United States, international and Canadian markets, to reduce the risk of being trapped in a low-performing market for an extended period of time, as was the case for buying and holding US stocks in the first decade of the new millennium. With a short-term perspective, institutions are likely to focus on recent performance and extrapolate this trend into the future. Yet a long-term approach reminds us that the fortunes of different stock markets wax and wane over periods of a decade or longer, in ways that are difficult to predict or recognize at the time. Diversifying helps institutions capture a fair share of market returns, without having to be too cautious or too confident about the future.

In Essential Element 4: Simplify, we showed that institutions can simplify how they get exposure to stocks and bonds, simplify how they deal with the investment industry and simplify the board meetings they use to govern the investment process. These points are of little concern to institutions who are reacting to events as they occur. Yet for institutions looking to build a long-term approach to investment and capital planning, simple is far more sustainable than complex.

In Essential Element 5: Balance risk, we outlined two key risks: short-term loss and long-term erosion. Institutions should consider both risks when setting a risk tolerance, in which they state their ability, willingness and need to accept risk. By understanding possible losses from different asset mixes, organizations will be better placed to follow a long-term plan. To win, it is important not to lose too much.

In Essential Element 6: Control cost, we showed a potential difference of over 2% between high fees and costs, versus low fees and costs. These fees and costs are comprised of investment management fees, holding costs and trading costs. Below we show the difference between growing at a net rate of 2.5% with low fees and costs, versus growing at a net rate of 0.5% with high fees and costs, applied to an initial balance of $10 million.

Table 3: Impact of fees and costs over the long term, net (after inflation, fees and costs)

Net return	After 10 years	After 20 years	After 30 years
Low costs: 2.5% growth	$12.8 million	$16.4 million	$21.0 million
High costs: 0.5% growth	$10.5 million	$11.0 million	$11.6 million
Difference	$2.3 million	$5.4 million	$9.4 million

Fees and costs may look small but, in depriving institutions of compound interest, they make a substantial difference over the long term. After 30 years, the difference between low costs and high costs is $9.4 million, almost equivalent to the entire initial balance of $10 million.

Industry incentives

Having reviewed the importance of time in investment planning, we can see that planning looks very different when institutions think in terms of decades rather than years. While one might expect that the finance industry would encourage long-term behaviour, this is often not the case. We will explore some of the incentives in the finance industry that can lead long-term investors away from long-term behaviour.

Large endowments and most pension plans are advised by investment consultants. These consultants, based on their deep experience in finance and reputation for impartiality, help endowments to set an asset mix, select investment managers and monitor their performance. In theory, endowments benefit from having access to the expertise of finance professionals who have a bird's-eye view of the investment landscape. In practice, these benefits are not quite so clear. As the investment consulting industry began, it provided a valuable service by comparing the performance of investment managers to appropriate benchmarks. Before the 1970s, it was difficult for investors to know exactly how an investment manager had generated returns. Was it from investing in small companies, backing certain sectors or venturing into foreign markets? Very few people really knew, including the investors themselves. As the investment consulting industry grew more mature and competitive, the practice started of comparing the returns of one organization to the returns of similar organizations. Time horizons also got shorter. Instead of comparing an investment manager's returns to a market benchmark over a full business cycle of 10 years, endowments gradually became accustomed to comparing themselves to peer organizations over periods of a few years. This introduced a large element of career risk for investment consultants. If the managers they chose went on to underperform the managers at other organizations for more than a few years, then the consultants faced the loss of their contract and its lucrative fee income. To reduce this risk, investment consultants became increasingly wary about backing any managers with below-average returns. This created the modern culture of institutional management, in which investment managers are given notice after two years of below-average performance and termination after 3-4 years.

As an example, the value strategy (buying companies with low prices relative to earnings, cash flow or other measures) has a strong track record but needs a moderately long horizon to succeed – at least five years and preferably 10. The career risk of recommending a strong form of this strategy can be too high for investment consultants. Anything that is too different can be too risky. If Warren Buffett were a no-name value manager, then investment consultants would have probably fired him at several points in his career for underperforming the S&P 500 index of US stocks – in the bear market of 1974-75 (missed by over 20% per year), in the technology bubble of 1999 (missed by over 40%) and in the market recovery of 2009 (missed by over 20%).[3] If the methods used to select and retain investment managers would have fired the most successful investor of the last century, then perhaps the methods are not very good.

While investment consultants focused increasingly on short-term performance because they did not want to lose their lucrative contracts with large institutions, the same was also true of the investment managers they selected. The managers, knowing they would be cut after 3-4 years of underperformance, started to increase the odds that they would not underperform. There are two ways to achieve this, depending on how they are being evaluated. If they are being compared to market benchmarks, then holding a selection of securities that is similar to the market would reduce the risk of underperforming the benchmark (this is known as "benchmark hugging"). If they are being compared to peer organizations, then holding an asset mix or following an investment strategy that is similar to peer organizations would reduce the risk of underperforming their peers (we could call this "peer hugging").

The problems of hugging are clear and costly. Active managers charge relatively high fees and often suggest they can outperform the market. Yet if they hold investments that closely resemble the market, while at the same time charging a fee of 1% of assets and incurring high trading costs to create the appearance of a differentiated strategy, then institutions would be better off buying the market through an index fund. If institutions are being sold a high-flying promise of beating the market, then they should be careful of paying for business-class but only getting economy.

Institutional incentives

We have seen that incentives can lead investment consultants and managers to reduce the risk of underperforming in the short term, even though there are better strategies available over the long term. Yet this culture of short-termism would not take hold unless institutions accepted and approved it. We will now turn to the incentives of the foundations and charitable institutions, which can make it difficult for them to benefit from a long-term investment horizon.

The first incentive is about being hands-off with investing, often because of a lack of experience or expertise. The executive director of a charity is typically selected for their ability to shape and implement a strategy, lead and coach teams and build relationships with stakeholders and community members. Very few of these roles are hired because of specialized knowledge of economics, finance or investment. As a result, leaders of large organizations and their board members will often defer to the knowledge of an investment consultant to set an asset mix and choose investment managers. Yet, as we have seen, investment consultants are more wedded to the short term than they would like to admit.

The second incentive is about being too vigilant. Charitable investors can interpret their fiduciary role to mean they cannot simply let an investment underperform for two or three years, which quickly leads to a bias for action. Yet, as we have seen, even strong investment strategies like value go through periods when they underperform; the ability to stick with them during these periods of under-performance is the price to pay for long-term success. John Bogle, the late founder of Vanguard and tireless advocate for patient investing, summarizes this aptly: "Don't just do something, stand there!".

The third incentive is about unduly comparing the organization to its peers. At first glance, it might seem reasonable for, say, a hospital foundation to compare itself to other hospital foundations (health care institutions can be quite competitive, in a good way). Yet this only works if all organizations have similar investment objectives, time horizons and risk tolerances. If one hospital foundation has just completed a major capital campaign to buy new MRI machines and is not expecting to fund more capital expenditures for another five years, then this is a very different time horizon from a hospital that relies mostly on small donations to make ongoing improvements to patient care. An organization should set its investment plan based on its own objectives, time horizon and risk tolerance – not those of other organizations.

The fourth incentive is about personal risk for leaders. In a short-term view of incentives, there is limited upside to investment success and substantial downside to investment failure. No one wants to be the board member of a school's investment fund that lost 30% in a market crash and has to announce that it won't be building the new swimming pool or theatre for the children. Stakeholder relationships can be tricky in charitable organizations and sometimes there are conflicts between groups that are hard to reconcile. This can cause a strong and stubborn bias towards the status quo, even if this is not particularly good. Fortunately, when thinking in decades rather than years, institutions can invert the incentives of short-term thinking. There is now substantial upside to investment success and limited downside to investment failure, provided there is a sound investment plan and a sound process to govern it.

Conclusion

What we have outlined so far – recognizing the role of time and how this affects the investment program and a variety of incentives – appears to be an investment challenge. We suggest that it is actually a leadership challenge, merely appearing in the guise of an investment challenge. Long-term investing success depends to a large extent on whether a handful of people at each organization – sometimes just one person – approach this challenge as leaders or managers. Leaders feel part of something larger than themselves and desire to provide something of value to others, including people they can't see or don't know, such as the next generation of patients, students or other beneficiaries of the organization. Managers are more present-minded, focused on administering the current state of the organization and keeping things working smoothly in the here and now. We will now apply a frame of leadership versus management to the aspects of time we have considered.

For the role of time, leaders will recognize the importance of clearly deciding the time horizon for which the organization is investing. This decision shapes all the other parts of the investment program. Recognizing that asset mix is the bedrock decision of investment planning, leaders will look far into the future – 20 or 30 years from today – and realize that holding cash instead of stocks and bonds over the long term is likely to result in the organization having significantly less funds to educate students, treat patients or build healthy communities. Even though holding cash might be comfortable and all but eliminates the possibility of losing money in any given year, leaders will recognize the need to take prudent, thoughtful risks to build for the future. Leaders will choose an asset mix that makes sense for their organization – a mix that is suitable for the organization in its current level of readiness and that provides board members with a long-term approach to capital planning.

For industry and institutional incentives, leaders will recognize the challenges that can prevent them from making the most of a long or perpetual investment horizon. They will build their knowledge of investing. They will be discerning about the advice they receive from those who talk about long-term investing but are motivated over short-term horizons, including many investment consultants and managers. Leaders will be clear that they are investing to achieve the objectives of their organization, not unduly comparing themselves to others. They will recognize that a bias to quick action is often not a good thing when it comes to investing. Most of all, if leaders find that the investment program is not well matched to the organization's long-term objectives, then they will have the courage to change the approach. While this change is not easy, strong leaders are able to unite people with different interests in a shared purpose, using time to its full advantage to invest for the community they serve.

[1] Jeremy Siegel, *Stocks for the Long Run* (2014), fifth edition, p. 96.

[2] Jeremy Siegel, p. 6, figure 1-1.

[3] Annual performance of Berkshire Hathaway versus the S&P 500, 2017 annual report, p. 2. http://www.berkshirehathaway.com/2017ar/2017ar.pdf