JULY 2016

What Does It Mean to Be a Long-Term Investor?

By Geoff Warren

This is the first in a planned series of papers addressing long-term investing and aspects of organizational design. Here, I focus on the traits essential to establishing and maintaining a long-term perspective. It is argued that long-term investors are best characterized by latitude and intent to focus on long-term outcomes. The notion is also raised that long-term investing has more to do with attitude or mindset, than holding period. Discussion of the determinants of long-term outcomes, and how investment organizations might be set up to successfully invest for the long run, are left for another time.

Characteristics of Long-Term Investors:

1. Latitude
2. Intent
3. Capacity for Patience
4. Trading Discretion
5. Investment Approach
6. Mindset/Attitude

It is worthwhile noting upfront that both short-term and long-term investors have roles to play, and can be successful. However, they approach investing in different ways, aiming to exploit different advantages. An overarching benefit of long-term investing is access to a broader opportunity set. Long-term investors can pursue a wide range of investments and strategies, including those available to short-term investors, although in practice they may choose not to do so. Long-term investors are more likely to be successful where they exploit advantages that stem from possessing discretion over when they trade, and a tolerance for short-term volatility or near-term underperformance. One such advantage is the capacity to adopt positions where payoff timing is uncertain, e.g., investing where long-term value exists, but may not be recognized by the market anytime soon, or to capture themes that unfold over time. Another advantage is the ability to capture opportunities that arise from the actions of short-term investors, perhaps because they are required to trade or are being short-sighted in their evaluations. Examples include contrarian investing, standing as the buyer of last resort in a crisis, and harvesting risk premiums that arise from the fears of those with shorter horizons. A further advantage is the scope to invest in illiquid assets. This offers return and diversification benefits through widening the range of accessible investments. Against this background, the question arises: what characterizes a "long-term investor?"

Two Key Characteristics of Long-Term Investors – Latitude and Intent

Long-term investors are best characterized by their *latitude* and *intent* to pursue long-term goals.

Long-term investing is a nebulous concept. Opinions vary on what it means to invest for the long term, or to be a long-term investor. Often the initial tendency is to view the issue through the prism of holding period. Surely long-term investors will hold investments for some years, if not decades. Deeper consideration leads to the conclusion that the length over which investments are held is an unsatisfying, and indeed unhelpful, way of describing what it means to be a long-term investor. Here it is argued that long-term investors are best characterized by their *latitude* and *intent* to pursue long-term goals.

In terms of *latitude*, long-term investors must have a *capacity for patience*. In turn, this is intimately related to possessing *discretion over trading*: the ability to decide when to buy, when to sell, and to continue holding as long as necessary. Long-term investors are subject to minimal pressure to trade because cash is needed soon; and are not concerned that they may lose funds—or their jobs—if their investments do not pay off immediately. But while latitude to invest for the long term is necessary, it is not sufficient.

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Long-term investors also need to play the part: they must have the *intent* to invest for the long term. In this regard, long-term investors are characterized by their *investment approach*. This will reveal itself in their investment philosophy and process, as well as the information used to make decisions. Long-term investing might also been seen as a matter of attitude, perspective, or even a mindset. Long-term investors are primarily concerned with long-term outcomes, fixing their sights on long-term goals and working towards them.

The concept that long-term investors are characterized by latitude and intent is fleshed out below. The next section considers existing definitions of long-term investing or investors, and identifies some influences on the horizon of investment organizations. The case is then put that holding period is an unreliable indicator, and that it is reasonable to expect long-term investors to trade on occasion. Determinants of capacity for patience are then discussed. This is followed by a description of what might distinguish long-term from short-term investment approaches. The paper concludes by raising the concept of long-term investing as a matter of attitude.

Definitions and Influences

A review of the literature uncovers no consensus around how to define the "long term."

A review of the literature uncovers no consensus around how to define the "long term," nor any accepted theory about what determines investment horizon (see Warren, 2014). However, a number of commentators offer definitions of either "long-term investing" or "long-term investors." These appear in Exhibit 1. The definitions associate long-term investing with varying combinations of three elements:

(i) Investment approach adopted

(ii) Discretion to hold for the long term

(iii) Intended holding period

No disagreement is offered with the first two of the items listed. Indeed, a key aim of this paper is to sketch out the nature of these elements, and what might influence them. But there are good reasons to dispute that intended holding period should be included on the list. This might seem strange to some, as it is natural to initially think of long-term investing as having something to do with the period over which investments are held. This issue is tackled in the next section, where it is argued that long-term investors only need to maintain their sights on the long term, and should not be required to continue holding regardless.

Exhibit 1: Definitions of Long-Term Investing or Long-Term Investors

Long-Term Investing

"fundamental, research-oriented investment approach that assesses all risks to the business and which has a focused discipline of seeking positive returns over the long-term business cycle" Marathon Club (2007)

"investing with the expectation of holding an asset for an indefinite period of time by an investor with the capability to do so" WEF (2011)

Long-Term Investor(s)

"someone who is never obliged to sell because of prevailing market conditions" Denison (2010)

"are less concerned about interim changes in asset prices, and instead are focused on long-term income growth and/or long-term capital appreciation both in their initial evaluation and continued interaction with their investments" WEF (2011)

"those who have the intention of holding an asset for multiple years and are not expected to liquidate their positions in the short term" Papaioannou et al. (2013)

"one who can hold any investment strategy for as long as the investor wishes" Orr (2015)

Ongoing concerns over excessive short-termism have spurred much commentary in recent years from academic, policy-related and investment-industry circles. The literature contains a range of research and opinions on what might determine investment horizon: refer to Warren (2014) for a detailed review. Exhibit 2, on the next page, lists some of the notable influences on the horizon of investment organizations. Here a key entity is the person responsible for making the investment decisions, usually the investment manager. The influences identified in Exhibit 2 are wide-ranging and somewhat overlapping. They broadly relate to three areas:

- **External influences** – These influences often cannot be controlled by an investment organization, or at best to a limited degree. Key elements include the nature of the sources of funding or liabilities, and how stakeholders such as investors in the fund behave, particularly in response to short-term underperformance. In many cases, these elements are prescribed. In other instances, an organization might have some influence over the capital they use, or the manner in which their investors respond. The structure of financial markets also seems to encourage shorter horizons, through: making trading easier and less costly; enticing action through a constant flow of information; encouraging ongoing scrutiny of recent performance; and the fact that much investment activity occurs in the context of long delegation chains where short-term results form the basis of monitoring.
- **Organizational design** – The structure of investment organizations can act as an important influence on the horizon adopted by its investment managers. Various aspects of organizational design are listed in Exhibit 2, with performance evaluation and remuneration singled out. A key issue is whether rewards are based on short-term performance, versus based on evidence of progression towards long-term objectives.
- **Investment decision process** – Investment horizon depends not just on the environment, but also the manner in which investment decisions are made. In part this will reflect the investment philosophy and process adopted, and the type of information that is fed into that process. The people responsible for investment decisions also matter: who they are, and how they go about making their decisions. Certain people are more predisposed to making long-term, non-consensus bets than others; or may be less susceptible to the range of behavioral influences that might shorten the investment horizon.

Investment horizon depends not just on the environment, but also the manner in which investment decisions are made.

Certain people are predisposed towards short-term or long-term perspectives.

Exhibit 2: Influences on Horizon for Investment Organizations

External influences	
1. Funding and liabilities	How soon the funds are needed, e.g., whether the investments are earmarked to support spending needs or liabilities that are immediate or deferred. Scope for funding to be withdrawn, e.g., potential for redemptions, margin calls, recall of capital provided, etc.
2. Stakeholder behavior	How stakeholders such as investors behave, in particular their potential reaction to short-term underperformance.
3. Financial-market structures	Financial-market structures tend to encourage short termism. Notable elements include the notion that trading has become easier and less costly; high availability and pace of information, which entices action; emphasis placed on portability, and return-based competition with reference to benchmarks and peer groups; mark-to-market reporting; industry structured as chains of delegations from owners to investors, which encourages monitoring by short-term performance.
Influences related to organizational design	
4. Organizational design	Whether organizational settings serve to foster a focus on short-term versus long-term outcomes. Elements include: guiding mission and beliefs; stated objectives; leadership; culture; tolerance for non-consensus views or short-term underperformance; framing of information; commitment to long term; tenure; how the chain of delegations and associated principal-agent relationships are managed.
5. Performance evaluation and remuneration	Whether investment managers are evaluated and rewarded for short-term performance versus progression towards long-term objectives.
Investment decision process	
6. Investment philosophy and process	Whether the investment process is aimed at short-term return generation through anticipating near-term price changes or delivering long-term outcomes. The latter may involve aiming to capture value over the long haul or perhaps dynamically taking strategic positions.
7. Information employed	Type of information that is input into investment decisions, e.g., whether the focus is drivers of share price fluctuations, versus drivers of long-term income streams and value creation over time.
8. Personal attributes of decision makers	Certain people are predisposed towards short-term or long-term perspectives; horizon adopted by the leaders within an organization; personal aversion to short-term volatility or loss.
9. Behavioral influences	Susceptibility to certain behavioral effects may reduce investment horizons, e.g., desire for immediate gratification, hyperbolic discounting, myopic loss aversion, recency, optimism and anchoring biases, framing and salience of short-term data, exposure to risk, ambiguity or pressure to decide, group-think and social culture.

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Holding Period Is a Poor Indicator of Investment Horizon

The objective of long-term investing should be to generate the best long-term outcome. For the purpose of discussion, think of this objective in terms of maximizing terminal wealth at the end of some distant horizon, subject to limiting the risk of suffering a permanent loss along the way. There is nothing to say that buy-and-hold is the best way to achieve this objective. To the contrary, trading is required to capture some of the advantages possessed by long-term investors that were mentioned in the introduction. Standing willing to trade along the path may be the optimal strategy for the long term, to the extent that it enhances terminal wealth or reduces risk of permanent loss. This entails having the discipline to sell when markets are overdone; and the patience to wait until the returns on offer are sufficiently attractive before investing. Such trades can be done in a manner completely consistent with maintaining a focus on the long term, and need not imply trying to anticipate the next market move. Some practical examples might help explain.

There is nothing to say that buy-and-hold is the best way to achieve this objective.

Example 1: Consider a growth or growth at a reasonable price (GARP) investor who buys a stock that is expected to generate strong earnings growth over the next 20 years, translating to a hypothetical 15% expected annual return at the current share price. The market wakes up to the stunning prospects offered by the stock, and the share price triples. The hypothetical expected annual return collapses to only 6% as a consequence. A long-term investor *should* exercise his or her sell discipline in this situation, and recycle the funds into another stock offering high long-term returns. This only improves the chances of building greater wealth over time. Continuing to hold the stock because it was "bought for the long run" would be, frankly, silly.

Example 2: Markets can at times run up to extreme levels at which they offer low expected returns, coupled with the risk of mean reversion that could lead to permanent losses that are never recovered. The U.S. equity market appeared to reach such a state in the tech boom towards the end of the 1990s. Arguably, bond markets might be in a similar position at the current time. A long-term investor might trade out of markets in such circumstances because the balance of reward-to-risk is out of kilter looking to the long term. If this requires sitting in cash and waiting patiently, then so be it. A genuine long-term investor might then trade back in when the prospects of generating adequate long-term returns are again sufficient.

Example 3: Long-term investment opportunities can arise on occasion from the actions of investors with shorter horizons. For instance, some institutional investors may be required to buy over-valued assets because funds have flowed in; or may become forced sellers of cheap assets because they have lost their funding. The latter occurred in the corporate bond markets after the Great Financial Crisis, for instance. Long-term investors may be able to build wealth for the long term by standing ready to take advantage of such opportunities. To do so requires a different approach to buy-and-hold. It means being constantly on the look-out for long-term opportunities, and standing ready to shift the portfolio around to capture them.

Underpinning the above examples is the notion that the investor remains focused on building wealth for the long term, while making investment decisions based only on long-term risk/return prospects. From this perspective, long-term investors are not characterized by their holding period, but rather the *perspective* that they adopt in making investing decisions.

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Latitude to Be a Long-Term Investor

Long-term investors must possess the latitude to invest for the long term. The key attribute is a *capacity for patience*, which in turn will be characterized by a high level of *discretion over trading*. Successful pursuit of long-term investing requires an ability to invest initially based on looking towards long-term outcomes, and then to continue holding if required. This implies the investor has the scope to decide when to buy, and more importantly when to sell. An investor with discretion over trading remains free to focus on finding investments that offer genuine long-term value potential and hence could pay off eventually; rather than worrying about when the pay-off might be realized. Such discretion underpins the pursuit of strategies to build long-term wealth such as: buying assets that are depressed under transitory pressures, and may remain so for an unknown time; avoiding overvalued assets that bring exposure to the risk of permanent loss; and delving into illiquid assets which offer a return premium in exchange for providing liquidity when it is most valued.

Capacity for patience and discretion over trading derive from a number of sources. Some drivers are beyond the control of an investment organization, to the extent that they are determined externally. For instance, the nature of funding and liabilities and the behavior of stakeholders—the first two influences listed in Exhibit 2—can dictate the discretion over trading possessed by an investment organization and the managers within it. For instance, closed-end funds may be better able to invest for the long term than open-ended funds due to greater security of funding. Organizations where investors are less likely to withdraw support because they are committed (or perhaps suffer from inertia or high switching costs) can be more confident that they have high discretion over trading and hence in their ability to invest for the long term.

The litmus test is when apparently sensible long-term bets fail to pay off initially.

The extent to which investment managers perceive they have discretion over trading can also stem from the internal workings of their organization. A manager is more likely to adopt a long-term approach if they believe that they have latitude to pursue opportunities that may not pay off immediately; to go against the current consensus when investing; or even to do nothing if the best course of action. This will be influenced by the objectives a manager is given, how their performance is evaluated, and how they are subsequently rewarded. Additional subtle yet important effects may flow from the leadership and culture within an organization. The litmus test is when apparently sensible long-term bets fail to pay off initially. Is the manager who made the investment greeted with understanding by their overseers and colleagues or admonished for failure?

Latitude to invest for the long term hence stems from the environment within which investment decisions are being made. Capacity for patience requires those making the decisions to feel that they have discretion to trade only when they feel it is appropriate. They are not put under pressure to generate immediate returns or constantly seen to be (re)acting. This will be heavily affected by aspects such as security of funding, and the expectations that are placed upon investment managers by both the organization and its clients. Only some organizations are set up to sustain a focus on the long term.

Nature of Long-Term Investment Approaches

A long-term investor needs to act like one. The discussion below contrasts the type of investment approach that might be used by long-term investors versus those with shorter horizons. While long-term investing will manifest in the approach to investing, it might also be viewed as an attitude or perspective rather than investment process. Discussion of the mindset that might be expected from a long-term investor is left for the concluding comments.

Those with short horizons act like *traders* or perhaps *speculators*, while those with long horizon behave like *investors*.

The hallmark of long-term approaches is a focus on the drivers of long-term outcomes: for instance, long-term expected returns, or determinants of portfolio value at the end of some long horizon. While a variety of investment approaches might fit the bill, the discussion below addresses long-term investing in the context of selection of stocks. The thesis is that long-term investors will focus on the drivers of long-term cash flows, while short-term investors will be primarily concerned with the drivers of price fluctuations. Another standpoint is those with short horizons act like *traders* or perhaps *speculators*, while those with long horizon behave like *investors*.

The dominance of the income component as a source of returns at longer holding periods is raised in earlier papers by the Brandes Institute (2012, 2015). This research attributed historical returns into income and capital appreciation over longer holding periods. It is augmented here with a forward-looking analysis aimed at highlighting what matters to investors of varying horizons. Exhibit 3 divides end-period (i.e. terminal) wealth over a range of holding periods extending out to 40 years into three components: (1) price at end of the holding period, (2) the sum of cash flows generated over the holding period, and (3) value generated from reinvestment of cash flows through the period. The calculations take the perspective of a buy-and-hold investor. Assumptions include a hypothetical return of 7.5% on both the asset and on reinvestment, and a hypothetical free cash flow yield of 5.5%. The calculations assume that cash flows are fully distributed and then reinvested by the investor at 7.5%. However, an equivalent result would arise if cash flows were reinvested back into (say) a company either through buybacks or earnings retention with the additional investments hypothetically earning 7.5%, and then accounting for the associated value separately. The assumptions underpinning Exhibit 3, on the next page, are contrived, but their magnitude is unimportant to the overall message.

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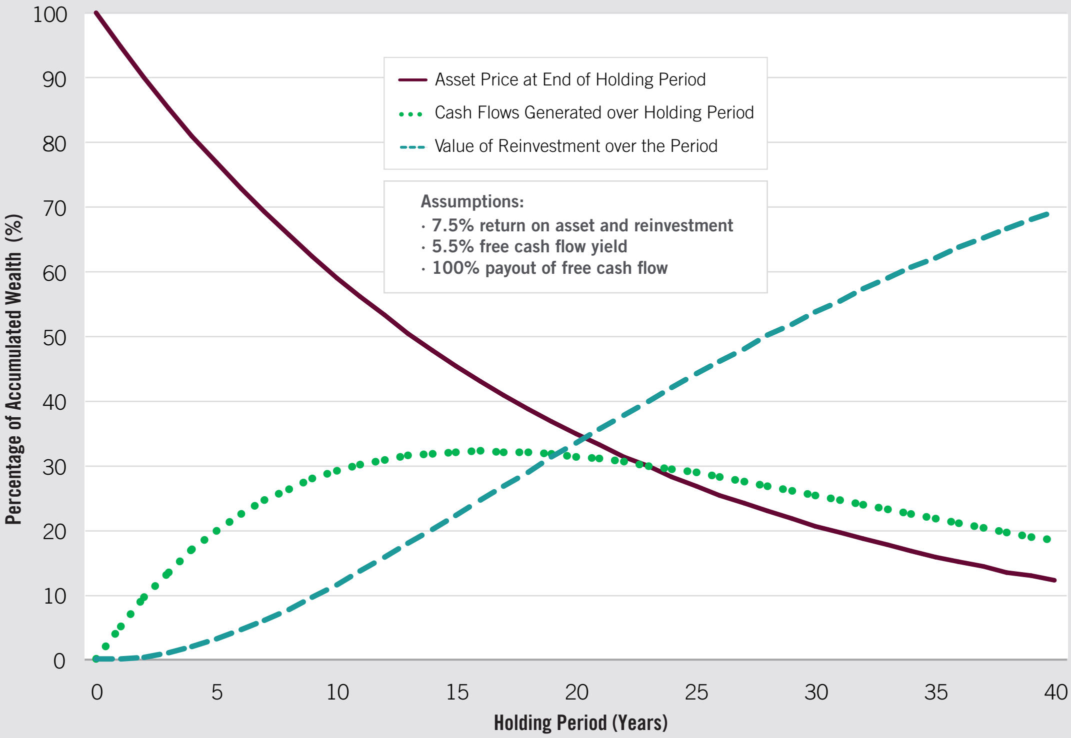
Exhibit 3: Hypothetical Contributions to Terminal Wealth over Different Holding Periods



Note: This hypothetical illustration is designed to aid in the discussion of concepts related to wealth generation over a number of decades. It does not represent or predict the performance of any specific investment. Actual results will vary. No investment strategy can assure a profit or protect against a loss.

For investors with an investment horizon approaching zero (e.g., today), 100% of their expected return is determined by the end-period asset price. For a 1-year horizon, the end-period price still dominates, comprising 94.5% of end-period wealth and hence expected return. The residual comprises of the cash flow yield of 5.5%. It hence should come as no surprise that investors with short horizons would spend most of their time focusing on price drivers. As horizon increases, the relevance of price declines, and the importance of cash flows and reinvestment begins to increase.

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After about 13-14 years, terminal wealth comprises around 50% end-period price, just over 30% cash flow and just under 20% from reinvestment. After 20 years, the weightings are 35% end-period price, 31% cash flow and 34% reinvestment—near enough to one-third each. The contribution from price eventually moves towards zero, while the value generated from reinvesting cash flows becomes increasingly dominant. Further, this attribution understates the importance of cash flows to the extent that revisions to expected future cash flows dictate the path of prices: if cash flows or earnings are revised, prices usually respond accordingly.

This simple analysis embeds a fundamental message. As investment horizon increases, the investment approach and the information on which it draws will shift from focusing on *price drivers* towards *value drivers*, including *cash flows* and the *use of cash flow* (i.e., reinvestment). Further, an investor with a long horizon may also be concerned with the price he or she pays for accessing future cash flows and by inference the implied *long-term expected returns*. In sum, a key indicator of an investor's horizon is the extent to which he or she focuses on the various parts of the future value equation.

The analysis provides a strong hint of the type of investment process and information set that will distinguish a long-term investor from a short-term investor. Short-term investors will tend to focus on anything that might move share prices in the near term. This could include aspects such as whether next period's earnings might surprise, who is buying or selling, news flows, and so on. Meanwhile, long-term investors will be more concerned with drivers of long-term value creation and/or income streams, and perhaps the price that they may pay to access the stream of expected future income. They will focus on aspects such as long-term earning potential, access to investment opportunities, management, and so on. Exhibit 4 elaborates on the contrasting types of information that may be the focal point for short-term traders versus long-term investors.

Exhibit 4: Information Used by Short-Term vs. Long-Term Equity Market Investors

Information used by short-term equity market investors:

As returns over the short term are dictated by price changes, short-term equity investors are most concerned with anything that might drive share prices. This will lead them to focus on aspects such as news flows, how the next earnings announcement might compare with market consensus, the actions of other investors, market themes, and of course how share prices might react to such things, or indeed anything that captures the attention of the market. They are not necessarily unconcerned with the drivers of long-term value. However, they will filter their interest through the prism of what these long-term drivers might imply for immediate share price movements, i.e., how will the market react?

Information used by long-term equity market investors:

Long-term equity investors are concerned with a company's capacity to generate cash flows and build shareholder value over time. This is typically revealed by aspects such as business profitability, growth opportunities and management quality. The underlying belief is that not only does cash flow generation matter over the long run, but also that share prices will ultimately converge towards a value supported by these fundamentals. Long-term investors may also be interested in the price paid for this cash flow, as this determines the return expected over the long term. Aspects that are the focus of short-term investors such as earning revisions will not necessarily be ignored. However, they will be considered only to the extent that they shed light on a company's long-term potential, or perhaps because they may spark an over-reaction that provides an opportunity to buy or sell at attractive prices. Although long-term investors would probably tend to trade infrequently, this is not necessarily a distinguishing factor. Trading in reaction to market opportunities or changes in long-term expectations may be fully consistent with optimal long-term behavior. What really distinguishes long-term investors is that they set their sights on the long-run drivers of value and returns, and look through the noise and near-term share-price movements.

What really distinguishes long-term investors is that they set their sights on the long-run drivers of value and returns, and look through the noise and near-term share-price movements.

It is worth noting that investment horizon is not a matter of value versus growth; but rather a matter of whether horizon extends to consider long-term value drivers. Value, GARP and growth investors can all potentially have long horizons. The difference is that value investors focus on the potential income from current operations relative to the price paid; growth investors focus on the scope for creation of additional value over time that is unexpected by the market, perhaps through reinvestment; while GARP investors try to consider the balance.

Hence whether the investment approach focuses on future cash flows or near-term price fluctuations is a key point of distinction between long-term and short-term investors. Short-term investors aim to anticipate the next fluctuation in price. Long-term investors look through price volatility to potential future cash flows, perhaps considering the price paid today. In doing so, they may respond to price fluctuations by attempting to exploit situations where prices and hence long-term expected returns are pushed to extremes.

Long-Term Investing as an Attitude

The above discussion contrasts long-term and short-term investing in terms of investment approach. However, long-term investing might be better described as an attitude, perspective or perhaps mindset. Long-term investors should be primarily concerned with long-term outcomes, not immediate gratification and should consider the many facets of investing for the long haul that extend beyond the investment approach. These facets include the desire to engage with wayward companies rather the exercise the "Wall Street walk," the manner in which an investment organization treats its stakeholders and staff, the desire to build a better world for future generations, a commitment to doing what is "right" and a belief that building something of value is better than rent-seeking. A long-sighted attitude embodies the willingness to accept short-term pain for long-term gain. Such attitudes and beliefs are often embedded within the character of organizations or individuals. Long-term investing does not arise merely from prescribing a particular investment philosophy or investment process.

A long-sighted attitude embodies the willingness to accept short-term pain for long-term gain.

This raises the importance of creating the right environment for long-term investing to prevail. The Brandes Institute has plans for research papers addressing the structure of successful investment organizations, and applying the principles to how an organization might be designed to successfully pursue investing for the long term.

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