Why the long term?

Quarterly Letter

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Foreword

"If one is mentally out of breath all the time from dealing with the present, there is no energy left for imagining the future."
Elise M. Boulding, sociologist, 1978

More than 40 years have passed, but I think the above words are just as relevant now as they were then. We're often too tired from putting out fires today to plan effectively for tomorrow. It's a problem Boulding called 'temporal exhaustion'.

We believe shifting the focus away from the here and now is crucial for investing successfully, but it's easier said than done. A 24-hour news cycle and our 'always-on' culture means people are fed a steady diet of data to guide their decisions. With limited time to digest the latest information before the next course arrives, it's hardly surprising investors feel under pressure to make hasty decisions when market winds change.

We prefer to take a more patient, long-term view. Our investment approach helps us distinguish between headline-grabbing risks with limited permanent impact and serious developments that erode a company's sustainable competitive advantage for the foreseeable future.

The new year is a time when people often revisit their long-term goals. A decisive UK election result before Christmas means there is now more assurance as we head deeper into 2020. Many investors may feel they have avoided a winter of discontent.

Our globally invested portfolios already performed well last year, despite ongoing uncertainties in the UK, so we're focusing on 2020 through a positive lens. But in this *Quarterly Letter*, we explain why prioritising the long term isn't just a seasonal perspective, it's a perennial pursuit.

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Cover image:
Envelope from a Presidential 'Thank you' sent to Nathaniel 1st Lord Rothschild (1840–1915), Senior Partner N M Rothschild & Sons, from President Theodore Roosevelt (1858–1919) in 1904. Courtesy of The Rothschild Archive.

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Why the long term?

Investors tend to be rewarded for their patience and staying invested

We crave instant gratification – fast food, fast fashion and fast delivery. Many people may argue these trends are evidence that rapid technological advances and consumerism have cultivated a demanding, throwaway society.

It's tough to disagree. A University of Massachusetts study[1] showed that internet users begin to abandon a website if a video they want to watch doesn't start within two seconds. Every additional second of delay caused a nearly 6% increase in the abandonment rate, with tolerance levels especially low among those with better internet speeds.

Have human attention spans always been just two seconds away from distraction? This seems unlikely, so it's tempting to point the finger at mass production, social media and mobile technologies for ushering in a new era of impatience. But correlation doesn't necessarily imply causation.

Our desire for instant gratification is because of a susceptibility to short-term thinking, which goes back much further than just the recent past. It's a part of our history; in fact, it's rooted in our prehistory.

In this quarterly letter, we ask the question why. Why do people struggle to overcome their short-termism? Why is it important for investors to try? And why and how do we, here at Rothschild & Co, focus on the long term?

Intuition or intellect?

Go with your gut. Trust your instincts. Follow your heart. English is full of idioms that romanticise intuitive, almost visceral decision-making. However, other common turns of phrase seem to suggest the opposite: look before you leap; haste makes waste; measure twice, cut once.

These contradictory adages reflect an inner human conflict between impulse and prudence, passion versus purpose, emotion against logic. We experience a similar psychological battle when we try to resist the allure of short-term rewards in expectation of a bigger pay-off in the future.

Sigmund Freud theorised that humans instinctively seek pleasure and avoid pain based on our biological and psychological needs. Freud called this tendency the 'pleasure principle', contrasting it with the 'reality principle', which he claimed was our conscious ability to evaluate the world around us and make rational decisions accordingly. While many of his theories are discredited today, the Austrian's work in this area had some striking insights.

More than a century after Freud first wrote about the pleasure principle, US researchers claimed to have discovered two competing areas of the brain that affect our behaviour when balancing short-term rewards against long-term goals. In other words, these aren't just philosophical struggles, we can see them happening at a physiological level.

In the study, 14 Princeton University[2] students were offered Amazon gift vouchers ranging from $5 to $40, as well as larger amounts if they were willing to wait for a predetermined period of between two and six weeks. While making these decisions, the participants underwent functional magnetic resonance imaging, which tracked their brain activity.

The results showed two areas of the brain are at work during decision-making. Both short- and long-term decisions fire up neural systems associated with abstract reasoning but when an immediate reward is available, a part of the brain more closely linked with emotion is activated. The students able to delay gratification had more activity in the logical portion of their brain, whereas emotion edged out reason for those who were unable to resist temptation.

The researchers were investigating dynamic inconsistency, a neuroeconomic concept whereby people make seemingly irrational economic decisions depending on how long they have to wait for a reward. For example, when given the choice between receiving £10 today or £11 tomorrow, many people will take the lesser amount immediately. However, when asked if they would rather have £10 in a year or £11 in a year and one day, they will often wait the extra day for the larger amount.

[1] www.cics.umass.edu/news/latest-news/research-online-videos, February 2013, University of Massachusetts

[2] Brain battles itself over short-term rewards, long-term goals, October 2004, Princeton University

Individuals who make these choices are showing 'present bias', as their decision-making changes when a reward is immediately available. This makes little sense from a purely economic perspective, so why do we do it?

Prioritising the here and now

Neuroeconomics experts describe our tendency to giver stronger weight to immediate outcomes as 'hyperbolic discounting' because we discount the value of future events.

The study of Princeton students is just one of many experiments that have examined dynamic inconsistency and present bias. Stanford University's 1972 Marshmallow Test is arguably the most well-known study into delayed gratification.

For those unfamiliar with the experiment, it involved offering children the choice between a small, immediate reward (a marshmallow or similar treat) or two of the same reward if they waited for a specified period of time. Would they have the self-control to wait 15 minutes for twice the bounty? Age is a key factor, with older kids more likely to understand the logic of resisting temptation.

The Marshmallow Test has inspired many copycat studies. Overall, they have shown that children who can delay gratification from a younger age go on to achieve more success in academia, the workplace and their social lives. Childhood self-control is also a good indicator of physical, mental and financial health in adults. The upshot is that people who think long term generally enjoy a better quality of life and accomplish their goals more effectively than those focused purely on the present.

Nevertheless, hyperbolic discounting research suggests that emotions trump logic when rewards are within our grasp, which is why humans can't always be relied upon to plan effectively for the future. We're fighting against our very DNA when we try. A widely accepted theory for our short-termism is that we're biologically wired to react quickly to imminent threats and rewards, an impulse that served our ancestors well.

Early Homo sapiens who understood that rustling in the bushes should be feared rather than ignored tended to survive longer than their more trusting companions. Similarly, why save resources for a tomorrow that may never come when we can fill our stomachs today? These behaviours helped us survive in a harsh, unforgiving environment where life-threatening dangers lurked behind every corner.

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Yet, in his best-selling book *'A Short History of Progress'*, Canadian author and anthropological expert Ronald Wright argues that cultural and technological advances have rapidly outpaced our physical evolution.

"We are running 21st century software on hardware last upgraded 50,000 years ago or more," Wright explains.

Put simply, our minds and bodies haven't developed quickly enough to deal with the different challenges and opportunities we encounter in a modern world.

The pitfalls of short-term thinking

We've covered a broad spectrum of science and philosophy, but of what practical importance is short-termism in business and investing? Ironically, the behaviours that have helped us survive and thrive throughout the millennia often work against us today.

Perhaps nothing epitomises corporate short-termism better than quarterly reporting. The UK introduced this requirement for public companies in 2007, but a review of the country's equity markets five years later by John Kay, professor of economics at the London School of Economics, was damning.[3]

Kay recommended abolishing mandatory quarterly reporting, which he described as "excessively frequent", in order to prevent companies from feeling pressured into short-term decision-making. The Financial Conduct Authority subsequently issued a new policy in 2014 to remove these requirements.

In the US, listed companies must still report quarterly. A McKinsey survey[4] found that 87% of executives and directors at US companies feel under pressure to deliver a strong financial performance within two years or less. Meanwhile, 55% of respondents at businesses without strong long-term cultures said they would delay a new project in favour of hitting quarterly targets.

[3] The Kay Review of UK equity markets and long-term decision making, July 2012, UK Government

[4] Measuring the economic impact of short-termism, February 2017, McKinsey Global Institute

You don't have to look far to see the consequences of failing to deliver sustainable, profitable business strategies. High streets up and down the country act as a cautionary tale for retailers that don't adapt quickly enough to evolving market conditions. The collapse of individual businesses is a blow for employees and the local community, but it pales in comparison to the impact of short-termism at a national and international scale.

Two of the main contributing factors to the global financial crisis were linked to hyperbolic discounting and present bias:

1. Many subprime homebuyers were enticed into purchasing properties based on loans with initial 'teaser' rates. Their focus on the immediate benefits of securing a home may have led them to discount the possibility they might not be able to afford their mortgage once favourable interest rate periods ended.
2. Bonus culture in financial institutions encouraged short-term, high-risk market behaviour, undermining many companies' solvency and contributing to systemic risk that eventually caused banks such as Lehman Brothers to collapse.

Lastly, it's not difficult to see how the human propensity for short-termism has led to worldwide climate change, species extinction and resource depletion.

There appears to have been a global wake-up call regarding short-termism in recent years.

Looking ahead

How about something a bit more uplifting? The good news is there appears to have been a global wake-up call regarding short-termism in recent years.

Within politics, countries such as Finland and Sweden have set up parliamentary advisory groups to prioritise strategies that solve humanity's long-term problems. Hungary has created a future generations ombudsman, while Wales appointed the world's first Future Generations Commissioner with statutory powers in 2016.

At a cultural level, organisers of the Future Library Project in Norway have asked esteemed writers, including Margaret Atwood and Elif Shafak, to write new literary masterpieces. The completed works are being stored in a specially designed room where they will remain unread until 2114.

On land owned by Amazon founder Jeff Bezos, a 200-foot clock is currently being installed in the mountains of west Texas. The clock has been designed to survive 10,000 years with minimal maintenance and interruption. It's an integral part of a Long Now Foundation series of projects to foster ultra long-term thinking.

The Paris Agreement, signed by more than 190 countries worldwide, sets out an ambitious framework to limit the increase in the global average temperature to less than 2°C (and preferably below 1.5°C) above pre-industrial levels. Over 60 countries have also committed to the Bonn Challenge, an initiative to restore 350 million hectares of deforested and degraded land by 2030. So far, 170 million hectares has already been pledged.

In business, mandatory quarterly reporting has already been dropped in the UK and the EU. Within three years of ending the requirement here, 40% of FTSE 100 and 60% of FTSE 250 companies no longer issued these reports to shareholders.

Leaders are already clamouring for a similar approach in the US. Larry Fink, chief executive of BlackRock, criticised the trend of "quarterly earnings hysteria" in an open letter to markets. In 2018, US President Donald Trump tweeted that he had asked the SEC to investigate quarterly earnings reports, suggesting changes may be afoot.

In a joint article for the *Wall Street Journal*, head of JP Morgan Jamie Dimon and Berkshire Hathaway CEO Warren Buffett wrote: "Quarterly earnings guidance often leads to an unhealthy focus on short-term profits at the expense of long-term strategy, growth and sustainability."[5]

We applaud these and many other developments. Rothschild & Co's investment principles are heavily underpinned by our firm belief in focusing on the long term for wealth preservation and growth. Our approach takes time, research and objectivity, as we look to counter short-termism and psychological bias within our investment processes.

Striking the right balance

Famed mutual fund manager Peter Lynch once wrote the following about investing: "The trick is not to learn to trust your gut feelings, but rather to discipline yourself to ignore them."[6]

[5] *Short-termism is harming the economy, June 2018, Wall Street Journal*

[6] *One up on Wall Street: How to use what you already know to make money, Peter Lynch, April 2000*

We're inclined to agree. However, should you always discount a hunch? Anyone who is familiar with Betteridge's law of headlines will recognise this is a leading question. The answer is no, with some caveats.

CPP Inc, the firm behind the popular Myers-Briggs personality test, believes it has isolated two character traits that many entrepreneurs share: intuition and perceptiveness. The research found entrepreneurs are more likely to be creative, risk-taking and impulsive. These findings echo previous studies exploring the entrepreneurial mindset.

Cognitive psychologist Gary A Klein saw similar impulse-led decision-making while studying firefighters and emergency services personnel.[7] He argued these professionals are able to quickly ascertain subtle clues, cues and anomalies before taking immediate, decisive actions. Clearly, our instincts can be a powerful force, even in a world where most people rarely have to make life or death choices.

Klein's work was an attempt to overcome the shortcomings of laboratory models of decision-making, which don't account for uncertainty in complex situations. Whether you're a medical worker or firefighter, big, high-risk decisions can lead to life-changing successes or failures, and there may be little time to stop and conduct deliberate and lengthy analysis.

It's easy to see how people may be tempted to apply this logic to investing. After all, what environments could be more complex or uncertain than global markets? Shouldn't we react quickly to market movements to optimise returns, particularly in the midst of a slowdown? Why wait?

We believe this is a false analogy, however, and caution against impulsive decision-making. When lives are on the line, inertia is a luxury that emergency services workers can rarely afford. The difference is that we're already confident in the health of our portfolio; we invest only for the long term to achieve consistent and steady returns within our risk budget. We don't need to make rash decisions because we've already done the research. Our choices are definitive but not hasty.

According to McKinsey, the revenue of firms with a long-term view cumulatively grew on average 47% more than less forward-thinking peers between 2001 and 2014. Their earnings and profits were also 36% and 81% higher, respectively, with less volatility.

Our own research also underscores the value of staying the course. Between 1993 and 2018, an initial investment of $10,000 in US stocks would have achieved 7.3% annualised returns and be worth roughly $60,000 if fully invested. Anyone who tried to predict short-term fluctuations during this time and were unlucky enough to miss the market's 10 best days would have seen annualised returns of just 4.4%. Their investment would be worth only half the amount – $30,000.

Overstaying your welcome

Companies with sustainable competitive advantages share something in common with fine wines, the best cheeses and high-quality leather. They usually get better with age. But we recognise that wine can turn to vinegar, cheeses spoil and leather eventually wears and tears.

At Rothschild & Co, we're always vigilant about the long-term prospects of our investments. No one is immune to hyperbolic discounting and other forms of cognitive bias, which is why we have rigorous systems to counteract short-termism and examine our decision-making through a logical, rather than emotional, lens.

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However, there's an important difference between a profitable long-term view and stubbornly sticking to a losing position. So, where is the tipping point? Let's look at two examples to see how we decide.

American Express (Amex)

We first purchased Amex in early 2013 due its powerful brand, reliable management team and solid position in an oligopolistic market. Two years later, the company announced the end of its co-brand partnership with Costco, which accounted for 10% of Amex's global cards in issue.

[7] Sources of Power: How People Make Decisions, 1999, Gary Klein

[8] Measuring the economic impact of short-termism, February 2017, McKinsey Global Institute

Humans have a tendency to focus on short-term risks and rewards, a trait that continues to have damaging real-word implications.

Would this development harm the long-term health of the Amex franchise? The markets certainly thought so; the company's share price fell from over $90 at the beginning of 2015 to just $52 by February 2016. We could have followed the herd and exited the position, but we wanted to delve a little deeper.

Was this a bump in the road or did the company now lack a vital competitive edge? Our team pored over the details, playing devil's advocate at every opportunity, before deciding there were no serious threats to Amex's brand or long-term growth. Quite the opposite; we were confident enough in the company to take advantage of the share price drop by adding further to the position.

We believe our conviction was justified. Despite the Costco loss, we estimate Amex's value has increased approximately 11% per annum over the last five years. The company's shares are now trading at $125, and we expect they should generate low double-digit returns annually over the next five to ten years.

AB InBev

Our research team reached a far different conclusion when beverage and brewing company AB InBev announced its intention to acquire SABMiller in 2015. We started investing in AB InBev in 2013 based on its impressive regional market shares, diligent focus on costs and strong history of integrating prior acquisitions.

However, the $125 billion purchase price of the SABMiller deal gave us pause for thought. We investigated numerous market scenarios that could affect expected returns and reviewed our outlook on mainstream beer prospects across AB InBev's key markets. This time, our findings urged caution; the size of the acquisition brought notable risks, while the opportunities to add value appeared much lower than with the company's previous buyouts, and volume growth had already fallen at AB InBev.

Unlike with Amex, all the signs pointed towards lower prospective returns for the future, so we promptly sold the shares at a price of €115 in October 2016. Since then, as we predicted, AB InBev has struggled to generate volume growth in its key markets and is now trading at €72.

Conclusion

Humans have a tendency to focus on short-term risks and rewards, a trait that continues to have damaging real-word implications. What separates us from other species is that we have the knowledge and the tools to overcome our psychological biases and look to the long term.

Whether we use these abilities in the worlds of business, the arts, entertainment, or elsewhere, the outcome is often more consistent, sustainable returns for ourselves and future generations.

Notes

At Rothschild & Co Wealth Management we offer an objective long-term perspective on investing, structuring and safeguarding assets, to preserve and grow our clients' wealth.

We provide a comprehensive range of services to some of the world's wealthiest and most successful families, entrepreneurs, foundations and charities.

In an environment where short-term thinking often dominates, our long-term perspective sets us apart. We believe preservation first is the right approach to managing wealth.

Important information