July 2014

"Nobody really invests with a 10-year time horizon anymore… institutional investors can't afford to think much beyond the next 6-to-12 months"

-Tobias Levkovich, Chief U.S. Equity Strategist at Citigroup
(Interview May 2014)

The Long-Term Investor Diet

Dear investor,

Most of us understand intuitively that decisions made with a long-term view will generally lead to a superior outcome than decisions made with a short-term payoff in mind. Just like dieting (trust me, I know!), the short-term approach, such as "The Grapefruit Diet," may generate results for a brief period of time (been there, done that!), but is unlikely to produce a lasting impact. In fact, such an approach can even have the counter effect -- by restricting your food intake for one week to grapefruits, the temptation to binge on all the "tasty" stuff can become overpowering, thus making it easy to regain all the lost weight (and then some). The only winner is my tailor.

The same can be said for corporate management and investors. We live in a world where too many executives and investors focus on short-term results, a fixation that ultimately detracts from both the health of the companies and the returns to their investors.

Dominic Barton, the managing director of McKinsey & Company, has done a lot of work regarding this issue of "short-termism." In 2013, McKinsey & Company and the Canada Pension Plan Investment Board (CPPIB) conducted a global survey of 1,000 board members and senior executives to assess this issue. Here are the surprising results, as published in the Harvard Business Review[1]:

- 63% of respondents said the pressure to generate strong short-term results had increased over the previous five years.
- **79% felt especially pressured to demonstrate strong financial performance over a period of just two years or less.**
- 44% said they use a time horizon of less than three years in setting strategy.
- 73% said they should use a time horizon of more than three years.
- **86% declared that using a longer time horizon to make business decisions would positively affect corporate performance in a number of ways, including strengthening financial returns and increasing innovation.**

[1] Focusing Capital on the Long Term, Dominic Barton and Mark Wiseman, Harvard Business Review Jan.-Feb. 2014

The dichotomy between the 79% who felt pressured to deliver results in two years or less and the fact that 86% believe that using a longer-term time horizon would lead to better results, is incredulous. When CEOs and board members feel pressured to act against the best long-term interests of the corporations that they are supposed to manage, something has clearly gone wrong.

Corporate boards and stock option compensation

Part of the problem can be attributed to corporate boards of directors who misapply the notion of "maximizing shareholder value." Although the concept is sound in principle, it has led to an excessive focus on the short-term share price rather than on creating lasting long-term value. The short-sighted practice of terminating thousands of employees because of a cyclical downturn, may help companies meet quarterly earnings expectations, but can also cause lasting damage to corporate culture and employee morale, thus impairing shareholder value.

The change in compensation structure over the past two decades has also had negative consequences. The use of stock options as remuneration was supposed to align managers of a company with its shareholders. Instead it has exacerbated short-termism, by rewarding management for brief spikes in share price, regardless of long-term corporate performance. It has become commonplace to read about CEOs who have made huge financial gains from stock options, only to be terminated later for poor performance.

One only has to look at such companies as Citigroup, AIG and Bank of America to see examples of senior management destroying value, while enriching themselves along the way.

Investors are part of the problem

Hedge funds and so-called "activist investors," with their relentless focus on short-term price appreciation regularly pressure management to make decisions at odds with creating long-term value. It seems almost daily that we hear about some fund or individual, often with a small stake (sometimes as low as 1-2%) in a company, but with a loud voice, threatening to fire management and/or board members if they do not take aggressive action to boost the share price. This, unfortunately, often comes at the expense of the company's (and their stakeholders') best long-term interests.

Share buybacks (in most cases) are an example of the madness that permeates boardrooms at most large corporations today. The folly of taking on debt to buy back shares, regardless of the price, has become business as usual for many public companies in North America in an effort to placate the activists. While the investing public may take pleasure in seeing a rise in their monthly statement due to this financial engineering, they may not realize that the hedge fund probably exited its position soon afterward, leaving the corporation in a weaker financial position. General Electric is one of countless examples. In 2007, GE bought back almost $14 billion of its shares at an average price of $38. One year later, during the financial crisis, it was forced to issue $12 billion of new shares at $22.25 each, thus destroying billions of dollars of shareholder value.

Added to all this is the fact that too many pension funds and consultants hire and fire investment managers based on their short-term performance. This increases the pressure on investment managers to speculate in shares they think can rise quickly, instead of looking for investments that offer downside protection and superior long-term return potential. Benjamin Graham, an early proponent of value investing, referred to short-term investors as "speculators" and his comment on their probability of success rings true today… ***"Outright speculation is neither illegal, immoral, nor (for most people) fattening to the pocketbook."***

We seek long-term value

When we started investing in Japan in 2010, the Japanese market was out of favor and offered compelling value. In fact, a number of excellent companies were actually trading for less than *net cash*. For the next 2 ½ years, our Japanese investments underperformed, which gave us the opportunity to add new positions to our portfolio. Our focus on value has since been rewarded and our Japanese shares have performed well. The same can be said for so many of our other holdings – Alcoa, Allstate, Hewlett Packard and ING, just to name a few.

All of these shares were first purchased when the companies fell out of favour with investors and had little in the way of near-term earnings visibility. In fact, all had actually declined in price after we initially bought them, thus affording us the opportunity to add to our positions at even more attractive prices. While each of these companies have very different attributes and business models, the common thread was that each of them were purchased when the share price was trading well below the intrinsic value of its business. Little attention was given to near-term catalysts or next quarter's earnings.

If a company's share price is trading at a steep enough discount to its underlying value, patient investors should ultimately be rewarded.

High Yield Bonds

A review of the high yield bond market and our high yield fund is available here: High Yield Quarterly

Final thoughts

Truly successful companies are those that foster a culture based on long-term value creation, often at the expense of short-term profits. These are the companies we seek to invest in.

As noted in the quote at the beginning of this letter by a Citigroup strategist, most professional investors today look at the market as though it was a horse race and spend their time "jockeying" to find short-term movers. The investment industry as a whole has become focused on beating a quarterly benchmark, instead of on preserving capital and creating enduring value for clients.

Instinctively, we all understand that quick fixes rarely deliver better outcomes than a well thought out long-term strategy. Our research effort is best spent on seeking out those companies that have a longer-term focus, whose share prices do not reflect their underlying value.

As far as dieting goes, despite the allure of losing five pounds in a week by eating only grapefruits, I have since adopted a longer-term strategy, which I believe will produce lasting results.

As always, we welcome the opportunity to discuss our outlook and investments with you.

Sincerely yours,

Lorne Steinberg
President

1

This document is prepared for general circulation to clients of Lorne Steinberg Wealth Management (LSWM) and is provided for information purposes only. It is not intended to convey investment, legal, tax or individually tailored investment advice. All data, facts and opinions presented in this document are based on sources believed to be reliable but is not guaranteed to be accurate, nor is it a complete statement or summary of the securities, markets or developments referred to in the report. This is not a solicitation for business. Past performance is not a guide to future performance. Future returns are not guaranteed. No use of the LSWM name or any information contained in this report may be copied or redistributed without the prior written approval of LSWM.