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Worth the Wait: Socially responsible investing in a near-sighted world

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In the investment world, the often used phrase "long-term" can mean very different things. It might indicate a one to two year period to some investors, while others may consider it to mean 20 years or more. While we will never have a singular definition of the term, it seems as though the "long-term" may be getting shorter. Data indicates that investment holding periods have been trending down over the past 60 plus years. As of December 2015, the average holding period of a stock on the NYSE was 8.3 months, down from 8 years at its peak in the 1950s and 1960s[i].

While the cause(s) of this trend is debatable, it certainly reflects the current state of our culture, in which information is often instantly accessible and news seemingly travels at the speed of light. You want to know who the 13th President of United States of American was. Just "Google" it (We know, common knowledge for all of you Millard Fillmore fanatics out there). You want to know when the next bus will arrive. There's an "app" for that. In a world where we, as consumers of information, are not expected to maintain our focus for more than 140 characters, it's no wonder we aren't holding stock investments for more than a period of months, on average.

What does that mean for investors and markets, specifically socially responsible investors?

A short-term mindset can impact the capital markets in many ways, at times leading to suboptimal decisions. For a company, it can be seen in the choice to avoid investments in profitable long-term projects, in order to improve the next quarter's earnings report. Pressure from investors, who themselves are often anxiously awaiting quarterly return numbers, is likely a contributor to short-sighted decisions by management. In our view, patient investing is a key driver of long-term financial performance. Further, looking beyond the next quarter is particularly relevant to socially responsible investors who measure return not only in dollar profits, but also in terms of positive environmental, social, and governance (ESG) impact.

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Take, for example, issues important to socially responsible investors such as energy efficiency and employee retention. While the long-term payoffs, financially, environmentally and socially, of these types of strategies are attractive, they sometimes come at the expense of up-front costs.

Are current investment periods too short?

At Pathstone Federal Street, we believe the answer to that question is yes, and there is a clear conflict between prevailing stock holding periods and the objectives of socially responsible investors, both as it relates to profits and impact measurement and generation. We believe that ESG company data, when considered over time, can offer insight into a company's values, profitability, competitive advantage, and risks that may not be apparent from a quarterly snapshot. For example, carbon intensity can fluctuate on a quarterly basis based on business seasonality which could obscure larger emissions trends. Workforce accident figures can look low in a particular quarter but may actually be increasing over time as a company shifts focus to increasing output at the sake of safety management. Further, inclusion of women and minorities on a company board results from longer-term cultural change at the company level and implementation over time.

Having advised socially responsible clients for more than 20 years, we understand the importance of keeping an eye to the horizon when it comes to evaluating investment and return, particularly as it relates to the "triple bottom line" which encompasses consideration of people, profit, and the planet.[ii] We offer the following suggestions that we think will promote a long-term focused and therefore more sustainable financial system that generates positive environmental and social impact and curbs negative externalities, all while delivering financial returns.

Align yourself with the right people

Surround yourself with people that speak your language. In selecting advisors and investment managers, look for professionals that have lengthy and proven experience with socially responsible investing and ask about their approach to long-term, sustainable results. Working with people who share and understand your objectives and values will help you stay in the game over longer time periods, rather than subject you to the whims of the day-to-day market.

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While we know that investors can take control of their own portfolio and have meaningful impact, we also acknowledge that there are shortfalls within the greater financial market system that conflict with the longer-term view needed by socially responsible investors.

Define Your Objectives

Work with your advisor to define your financial, environmental and social return goals. Complement different outcome scenarios with actionable responses (think "If…then…" statements). A thoughtful plan will remove the emotion from the decision making process, reducing the inclination to react to short-term news or performance.

"Be the change you wish to see…"[iii]

Be an agent for change and reflect the market shifts you want to see in your own portfolio. Be open to a creative and flexible approach that may look different from the market and incorporate unique return and risk opportunities. The more investors take the long-term view, the more quickly the markets will begin to acknowledge and embrace the importance of environmental and social factors on companies' performance.

While we know that investors can take control of their own portfolio and have meaningful impact, we also acknowledge that there are shortfalls within the greater financial market system that conflict with the longer-term view needed by socially responsible investors. Below are a few systemic changes that we believe would foster a longer-term focused, more sustainable investment environment.

Tax incentives for long-term investments

The Internal Revenue Service (IRS) makes a very clear distinction between a short-term and long-term investment as it relates to the taxation of realized gains - one day. An investment held for one year or less is considered a short-term investment, the realized gains from which (if any) are taxed at the higher income tax rate. An investment held for more than one year is a long-term investment, the gains from which (if any) are taxed at the lower capital gains tax rate.

In theory, this correctly incentivizes taxable investors to prefer longer holding periods over shorter by increasing the amounts of proceeds they keep, after taxes are paid. The problem is that there are generally no additional distinctions made between one day more than one year and very many days, months or years more than one year.

If you ask any investment manager what their preferred client looks like, we are willing to bet you will hear the terms "loyalty" and "long-term" more often than not.

A continued sliding tax scale would appropriately incentivize investors to push their timeframe further into the future. There should be a difference between an investment held for barely more than a year and one held for 7,300 days.

Improved quality and comparability of ESG data

While 81% of companies in the S&P 500 Index issued sustainability reports in 2015[iv], the data reported varied considerably. For example, some companies report greenhouse gas emissions from operations alone whereas others report on emissions from the entire supply-chain, making an "apples-to-apples" comparison difficult. Improved ESG data should enable investors to better identify risks and discern companies that are more sustainably run and therefore better positioned to maximize returns over the long-term. The Sustainability Accounting Standards Board (SASB), which promotes the disclosure of material sustainability factors via its reporting framework, and The Task Force on Climate-related Financial Disclosures, which aims to mitigate market instability related to climate change by making climate information readily available to a broad swath of investors, are making strides to improve corporate ESG disclosure. If successful, these efforts will result in broader consideration of ESG factors by managers, which we feel will lengthen investment periods, and improve performance over the long run.

Fee Structures

A key part of investment manager due diligence focuses on portfolio manager tenure. One of the reasons investors reward investment managers with incremental assets (and therefore additional fees) is often the length of time the key persons have been with the firm and their commitment to the strategy. And vice versa, if you ask any investment manager what their preferred client looks like, we are willing to bet you will hear the terms "loyalty" and "long-term" more often than not.

Why not reward investors for loyalty?

Investment managers have the ability to incentivize long-term investor relationships by offering fee discounts for investors that have been a client for a pre-specified period of time.

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This would likely foster a more loyal, long-term oriented investor base which in turn would provide investment managers more flexibility to make long-term investments and remain invested through difficult periods.

This idea could also extend to equity investments in public companies. The Generation Foundation in collaboration with Mercer and Stikeman Elliott LLP, published a research report in 2013 that evaluated the potential for loyalty-driven securities, which would reward long-time company shareholders with additional dividends, voting rights, etc. While ultimately the study concluded that loyalty-driven securities would likely not significantly alleviate short-term market pressures[v], the need to better align asset owners and investors around timeframe is clear.

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Conclusion

In today's fast paced world, waiting for anything seems obsolete. Despite a growing cultural expectation of instant gratification, at Pathstone Federal Street we remain firm believers that investment returns come not only from sound due diligence and judgment, but also from patience. Patient investing, with a focus on long-term outcomes is particularly relevant for socially responsible investors. As investors we need to continue to view returns from a long-term perspective, as well as encourage changes that improve the incentives of our financial system.

The results are worth the wait.

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[i] "Lengthening the Investment Time Horizon", MFS White Paper Series, July 2016. https://www.mfs.com/wps/FileServerServlet?servletCommand=serveUnprotectedFileAsset&fileAssetPath=/files/documents/news/mfse_time_wp.pdf
[ii] "Triple bottom line" The Economist, November 17th 2009 http://www.economist.com/node/14301663
[iii} Although most folks think Gandhi is responsible for this token of wisdom, we were unable to attribute the quote. Therefore, we are noting that it is commonly attributed to Gandhi, but that its actual source appears to be unknown. http://www.nytimes.com/2011/08/30/opinion/falser-words-were-never-spoken.html?_r=0
[iv] http://www.ga-institute.com/nc/issue-master-system/news-details/article/flash-report-eighty-one-percent-81-of-the-sp-500-index-companies-published-corporate-sustainabi.html
[v] "Building a long-term shareholder base: assessing the potential of loyalty-driven securities." The Generation Foundation, in partnership with Mercer and Stikeman Elliott, https://www.genfound.org/library/

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