EACC – Long Tem Investing – November 4th, 2014

Capitalism and long term investment.

Capitalism has always existed at the frontier between free enterprise and regulation: it is freedom under constraint.

As Jean Tirole, this year's Nobel laureate, reminds us, regulation can have a positive or a negative impact on the economy. The Chicago school principle of *"competition conquers all"*, even in highly concentrated industries, has been replaced by a more advanced approach, using game theory and information asymmetry, and showing that the optimal equilibrium between regulation and business is fairly complex.

But the problem with regulation is that, in many areas, government and international institutions have become very much short-term focused and unable to push large scale changes. New regulation can be overwhelming, like in the case of finance, or desperately inadequate like in the case of climate change. Not to say that one can't put any hope in the

political process – the TTIP is well under way, and I know that the EACC is hugely supportive.

So part of the solution in defining new ways of investing and managing business is more self-regulation, more self-discipline. One key question in particular: has Capitalism become too focused on the short-term?

In principle, no. The horizon of investors does not influence a firm's long term strategy. Why? The CEO knows that if investor A plans to sell after just a few months, an investor B will have confidence in the outlook of the firm, before investor C takes over, etc: there is therefore a continuous chain of owners who all bet on the success of the firm in the long run because they base their investment decision on today's price, including ALL future earnings, not just earnings in the next few quarters. They have a different timing but share the same price reference. This is exactly what is stipulated by the 1930 Separation Theorem of Irving Fisher in its *Theory of Interest*. Not a new concept…

In practice, executives do feel the pressure of markets. As noticed by Dominic Barton (1), 44% of them admit using a time horizon of less than 3 years in setting

strategy, while 73% say they *should* use a time horizon of more than 3 years. A Bank of England study (2) shows that stock prices in the UK and the US have historically over-discounted future returns by 5% to 10%, and there is evidence that over the long term, private equity returns are significantly higher than those of publicly held companies.

Are investors responsible? They can certainly do better. As also pointed out by Dominic Barton, they have many options at their disposal to further maximize their investment value:

1. Insist publicly on long term management (e.g. Warren Buffet uses a rolling five-year return of the S&P as benchmark),

2. Request companies to provide long-term metrics,

3. Play an active role in the regulatory debate. And the list is not exhaustive.

But in my opinion, investment horizon remains mostly irrelevant to public companies. Long-term portfolio optimization is of course desirable, but for investors' clients, not for the companies they invest in. Ultimately, change will have to come from the corner

office: whether the CEO is better inspired by board compensation practices or pressure from investors, he/she has to believe in a long term vision and engage the investment community.

With that, I will leave the floor to John Studzinski, senior Managing Director at Blackstone.

Thank you.

(1) *Focusing Capital on the Long Term*, by Dominic Barton and Mark Wiseman, Harvard Business Review (Jan-Feb 2014)

(2) *The Short Long*, by Andrew Haldane and Richard Davies, Bank of England (May 2011)