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Myth Busting, Popular Delusions, and the Variant Perception

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Excerpts from a talk given by Michael Mauboussin to the Greenwich Roundtable on January 30, 2020

Good morning. It's a real pleasure for me to join you today, as these roundtable sessions always prompt me to organize my thoughts on important topics. This morning's theme is a particularly interesting one because it provides an opportunity to critically examine some issues that are often understood superficially.

I should mention that I first participated in a session with the Roundtable 15 years ago, and was on a panel with the great economist, historian, and author, Peter Bernstein. I said then that I wanted to grow up to be like Peter Bernstein. Fifteen years later, I have aged but I have not grown up!

I will address four myths or popular delusions:

- The first one relates to short-termism. You hear a lot of fretting about the deleterious impact of short-termism, without a lot of concrete evidence for its existence. We'll critically examine some of the arguments to see if they hold water;
- The second is the idea that dividends play a large role in equity returns over time. I will demonstrate that price appreciation is the only source of investment return that increases accumulated capital;
- Third is the notion that investing in money-losing companies is a bad idea. It can be a bad idea, but much more nuance is necessary; and
- The final one relates to the idea that the rise of indexing has made it easier to be an active manager.

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I. Let's start with the first topic, that of short-termism. We'll define it as the tendency to make decisions that appear beneficial in the short term at the expense of decisions that have a higher payoff in the long term. This tends to come in two flavors, investor short-termism and managerial short-termism.[1]

It is easy to find concerns about short-termism throughout history—I have examples that go back decades. But a quote from a *Harvard Business Review* article captures the current mood:

> ". . . the shadow of short-termism has continued to advance—and the situation may actually be getting worse. As a result, companies are less able to invest and build value for the long term, undermining broad economic growth and lowering returns on investment for savers."[2]

Let's look at three aspects of this. The first is why some shortening of time horizon may be fully justified by the economic facts. For example, consider the rate of diffusion of new technologies: it took 71 years for one-half of the U.S. population to get a telephone, 18 years for a color television, and 10 years for internet access. As these diffusions speed up, so does change.[3]

Another is asset lives. The asset lives for technology companies are generally 6-7 years, whereas asset lives for energy and materials companies are roughly 17-18 years. As the composition of the economy and the stock market have shifted away from asset-heavy to asset-light industries over the past 30 years, the average asset life has shrunk. Further, it turns out that governance scores, as calculated by Credit Suisse HOLT, are highest for industries with the longest asset lives and lowest for businesses with the shortest asset lives.

The most fundamental way to assess the market's short-termism is to look at asset prices themselves. It is easy to find pundits who suggest the stock market is overvalued, and this notion is backed by evidence such as the CAPE ratio.[4]

That alone should give some pause to those arguing for short-termism: high valuations mean the market is recognizing and paying for cash flows many years into the future. It's the very opposite of short-termism.

Here's a simple exercise I do with my students at Columbia Business School to make this point. I take five stocks from the Dow Jones Industrial Average and calculate the present value of the dividends they are expected to pay over the next 5 years, according to estimates by *Value Line* (see exhibit 1). That value represents only 11 percent of the prevailing equity value, which means that more than 90 percent is for cash flows beyond 5 years. Assume buybacks that are as large as dividends and you still only get to about 20 percent. In other words, most of the value is reflected in long-term cash flows.

Exhibit 1: Percentage of Value Attributable to Dividends beyond the Next Five Years

Company	Price, 12/31/2019	Cumulative Present Value, Next 5 Years of Dividends	Percentage of Share Value Beyond 5 Years
American Express	$124.49	$9.01	92.8%
Coca-Cola	55.35	7.89	85.7
Merck	90.95	12.72	86.0
Microsoft	157.70	11.37	92.8
Procter & Gamble	124.90	14.49	88.4
Average			**89.1**

Source: Value Line Investment Survey.

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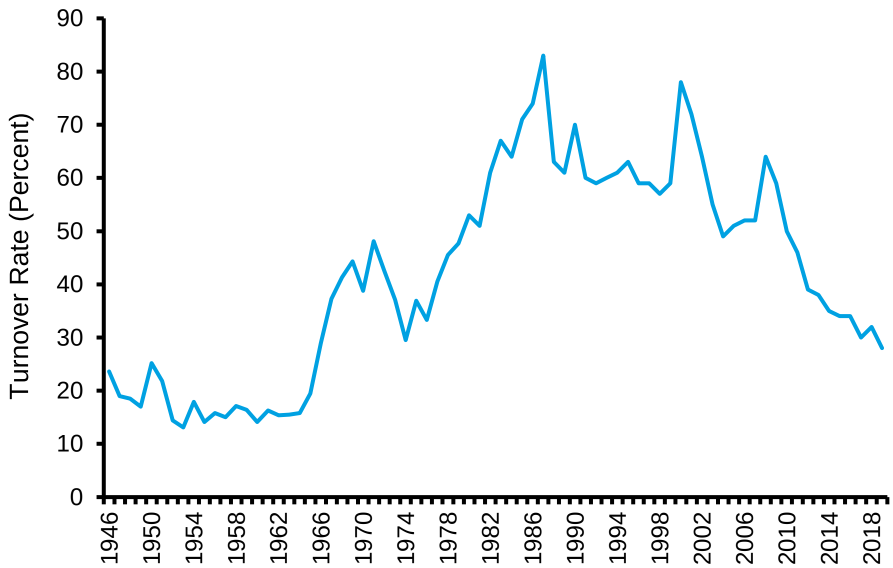
Perhaps the most popular argument for short-termism is the holding period of money managers. For example, Michael Porter, a professor known for his work on competitive strategy, noted that “the average holding period of stocks has declined from over seven years in 1960 to about two years today . . . it is perhaps the most telling evidence of shortening investor horizons.”[5]

Porter is indeed correct: portfolio turnover was much lower in the 1950s and 1960s than in recent times.[6] But you might ask why that is.

A long-term chart of portfolio turnover shows a spike starting on May 1, 1975 (see exhibit 2). That was the day commissions on stock trading were deregulated. To give you some sense of the situation, the cost of trading 10,000 shares of a $40 stock was $0.43 *per share*. And, of course, bid-offer spreads were expressed in eighths. So the cost of trading was vastly higher, hence limiting activity.[7]

Exhibit 2: Portfolio Turnover, 1946-2019



Source: Bogle Financial Markets Research Center and Investment Company Institute.
Note: U.S.-based mutual funds; Annual turnover rate is weighted by assets.
Portfolio turnover is a measure of how frequently assets within a fund are bought and sold by the managers. Portfolio turnover is calculated by taking either the total amount of new securities purchased or the amount of securities sold - whichever is less - over a particular period, divided by the total net asset value of the fund.

Further, turnover is actually *down* in the last 20 years. The latest reading of asset-weighted turnover is 25-30 percent, the lowest since the 1970s.[8] Now there are entities that trade frequently, but they are only around because the cost to trade has come down so much. For example, index funds weren’t viable prior to 1975 because of cost.

It’s also worth noting companies such as Amazon.com have taken a long-term view and have been rewarded by the market. The idea that a company that has been public for 23 years is loved only because it trained its shareholders doesn’t really fit the narrative of short-termism.[9]

Let me finish this point with a couple of thoughts. I recognize that managers and investors feel pressure to deliver short-term results. All of us who seek to have successful long-term careers also feel short-term pressure—and that’s because the long term is an aggregation of short terms. The key is to do the right thing.

Second, the reason investor holding periods are shorter than the number of years of cash flows reflected in stock prices is that *investors make short-term bets on long-term outcomes*.[10] If you want to understand the market's time horizon, do not look at, or talk to, the investors. Look at the market, which is a product of all investors.[11]

II. The second myth is about the role of dividends in capital accumulation. In a paper he co-authored, Peter Bernstein wrote, "These data put the lie to the conventional view that equities derive most of their returns from capital appreciation, that income is far less important, if not irrelevant."[12] A large investment management firm put out research that was ever more emphatic, stating, "Some may be surprised to learn that 90 percent of U.S. equity returns over the last century have been delivered by dividends and dividend growth."[13] Yes, that would be surprising—especially if it were true.

Let's take a step back. The reason we save, or defer current consumption, is to accumulate capital to satisfy future liabilities, whether it's paying for a child's college education or retiring comfortably.

When we discuss the stock market in general or specific stocks, we often refer to "total shareholder return" (TSR), which assumes that dividends are reinvested with no friction. Here is the equation to calculate TSR:

$$TSR = g + (1 + g) * d$$

In this equation, g stands for the stock price appreciation rate and d stands for the dividend yield.

The focus on TSR can lead to a couple of points of confusion.[14]

The first is that almost no one earns the TSR for a stock that pays a dividend. In order to do so, you must have an automatic dividend reinvestment plan with zero taxes. The number of people who fall into this camp are de minimis. Most people spend the dividends they receive, and most funds allow the sum simply to go to cash. So one should be very careful relying on past TSRs to plan for the future.

The second is the belief that dividends are the main driver of investment performance. In reality, *price appreciation is the only source of investment returns that increases accumulated capital.*

To understand this, let's slow down the process. Say you have a $100 stock that pays a $3 dividend. The day that dividend is paid, you have a stock worth $97 and a dividend worth $3 (the stock is actually marked down on the ex-dividend date). You earn the TSR only if you reinvest the full $3 into the stock to restore your investment to $100. From there, it is clear that *price appreciation* is the driver of accumulated wealth.

Your capital accumulation is a function of how much you invest, how long you invest, and price appreciation. By the way, there is also massive confusion about share buybacks, which I won't go into now.

I will add that there is very robust evidence about the relationship between asset growth and TSRs. Companies that have grown assets rapidly have tended to deliver poor returns, whereas those that have grown modestly, or even contracted, have done well. So returning capital to shareholders is important.[15]

One last note: much of what I've just discussed about dividends is summarized in a paper that was published in the *Journal of Portfolio Management* in 2006 by my mentor, collaborator, and friend, Al Rappaport. Peter Bernstein read the paper and called it "masterful" and wondered out loud why no one had pointed out this analysis to him before. Bernstein was still open to learning at the age of 86!

III. The third myth is about companies that lose money. Jay Ritter, a professor of finance and a leading authority on initial public offerings (IPO's), reports that 74 percent of companies that did an IPO in 2019 lost money, which is about where the level was in 1999, near the peak of the dot-com bubble.[16] Further, about 40 percent of listed companies in the U.S. lose money—all this against a backdrop of a solid economy.[17] The implication is that things have returned to a frothy state—and certainly the saga of WeWork fanned the flames of that narrative.

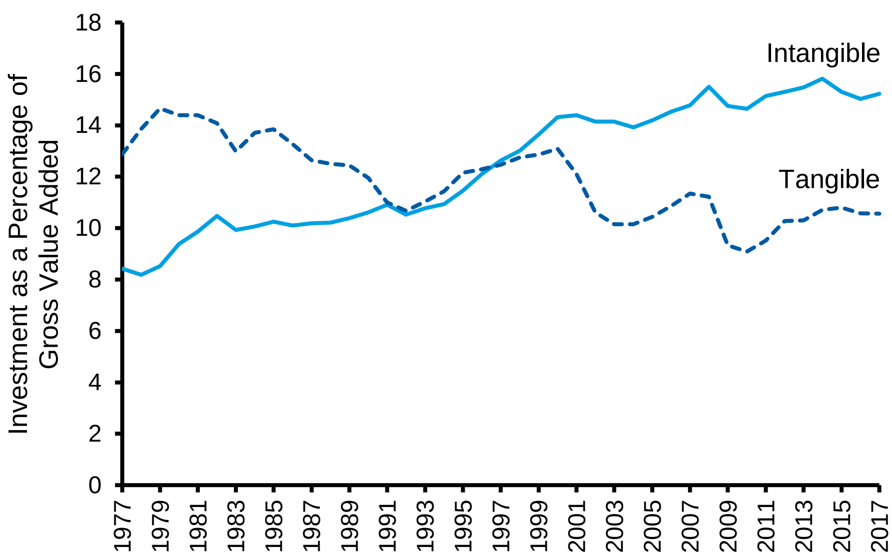
Here's a short quiz for you: what if I offered you shares of a company just listed on the New York Stock Exchange and told you with absolute certainty it would have negative free cash flow for each of the next 15 years. Would you buy it?

Well, there was a little company like that and it was called Wal-Mart Stores, Inc. From the beginning of 1972 through the end of 1986, Walmart generated TSRs of 33 percent versus the S&P 500's 11 percent. Investors in Walmart would have ended the period with almost 16 times more capital than investors in the broader market.

Walmart was such a good stock because it earned a very high return on its investments. In those cases, you want a company to invest as much as it possibly can—even if the investment is larger than earnings and the company has to access external sources of capital to do so.

So what does that have to do with what's going on now? There has been a watershed change in the form in which companies invest. In 1977, tangible investment was 2 times that of intangible investment. Today, intangible investment is 1.5 times tangible investment (see exhibit 3). Tangible investments appear on the balance sheet; intangible assets tend to appear on the income statement as an expense.[18]

Exhibit 3: The Rise of Intangible Investments, 1977-2017



Source: Unpublished update to Corrado and Hulten (2010) using methods and sources developed in Corrado and Hao (2013) and in Corrado et al. (2016) and Corrado et al. (2017) for INTAN-Invest© and the SPINTAN project, respectively. The SPINTAN project was funded by the European Commission FP-7 grant agreement 612774.
Note: Nonresidential business investment relative to business sector gross value added.

So what's the solution? If you want apples-to-apples comparisons, you must capitalize the investments that are now on the income statement. In other words, put them on the balance sheet as we used to. The immediate impact is that earnings and book value both go up.[19]

This relates to the challenging time for value investors, who tend to build portfolios that rely on statistical factors such as price-to-book and price-to-earnings multiples. Baruch Lev and Anup Srivastava, professors of accounting, made these adjustments and found that 40-60 percent of stocks that had been classified as "value" or "glamour" shift categories. Further, they found that the adjustments lead to factors with much better signals for building portfolios.[20]

This also addresses the concern that companies are underinvesting and returning too much money to shareholders. If investments on the income statement are properly categorized, firms have actually been increasing their operating investments over time.

I believe this myth has created opportunity for investors who are willing to roll up their sleeves to really understand unit economics.[21] If you knew how good Walmart's store economics were, you would have stood behind them applauding as they spent more on investments than they earned in income. Likewise, some companies today are losing money but have extremely attractive economics, and others are losing money the old-fashioned way—with bad business models.

IV. I hear a lot of successful investors say that the rise of indexing has made it easier to be an active manager. Seth Klarman, the founder and CEO of the Baupost Group whom I admire deeply, echoed this refrain when he said, "[Indexing] should give long-term value investors a distinct advantage. The inherent irony of the efficient market theory is that the more people believe in it and correspondingly shun active management, the more inefficient the market is likely to become."[22]

On the surface, this sounds like a plausible case: fewer people are competing and less information is finding its way into markets, hence it's easier to express your skill by finding mispriced assets. But I think the opposite may be true, and here's why.

A good starting point is "The Arithmetic of Active Management" by professor of finance and Nobel-Prize winner, Bill Sharpe.[23] The idea is simple: Before costs, the return on the average actively managed dollar will equal the return on the average passively managed dollar. And after costs, the return on the average actively-managed dollar will be less than the return on the average passively-managed dollar.

Now this isn't by itself any revelation for active managers. Alpha before fees is zero by definition. What is important is that for you to earn positive alpha, someone on the other side of your trades has to earn negative alpha.

To make this more vivid, imagine that I invite you to my house Friday night to play poker, and let's assume that you want to make some money. Upon receiving the invitation, your first question should be, "Who else will be there?"

If I tell you there will be some rich people who are much worse players than you are, you'll immediately make plans to join me. There's no guarantee you'll win, but over time your skill will allow you to take money from those patsies.

On the other hand, if I tell you that the players who are coming over are all better players than you are, you should arrange some alternative plans. In this case, it should be clear that *you* are the patsy—which is not good if you like to keep your money.[24]

I think the poker story carries over well to the investment management industry. My conjecture is that the investors who have turned to indexing are on average the weaker players.

To stretch this analogy, the weak players are sitting at your poker table drinking your beer but are not playing—so they can't win or lose. And the reason I mention that they are drinking your beer is because they really are free riding: indexers rely on active management for price discovery and liquidity. So active management fees subsidize the index management industry.

So if my argument is reasonably accurate, you are left playing the stronger players, making it harder, not easier, to generate risk-adjusted excess returns, or alpha. And while there's little doubt that indexing has and will create distortions in markets, there remain a substantial number of active managers at the ready to arbitrage those opportunities.

In summary, I want to encourage you to always go back to first principles when considering what the pundits say or assert. The motto of the Royal Society, "Nullius in verba," is a useful way to think. It is meant to mean "take nobody's word for it." The investment industry is, and has always been, replete with myths and delusions. Our job is to bust them whenever appropriate.

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Please see Important Disclosures on pages 9-11

Endnotes

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