

PETER SHAPIRO

“OUR FAVORITE HOLDING PERIOD IS FOREVER”

LONG-TERM INVESTING IN A SHORT-TERM WORLD

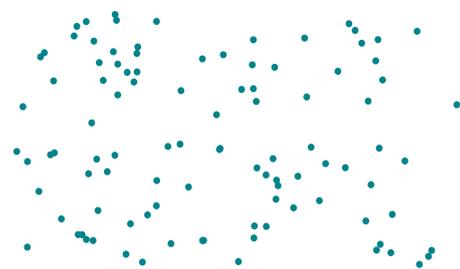


Peter Shapiro, CFA
Portfolio Manager

Towards the end of World War II, German forces began firing V-2 rockets at London. The supersonic rockets terrified the British, as they landed and exploded before people on the ground would hear them, and their speed and trajectory made the rockets nearly impervious to anti-aircraft fire. Local newspapers began to publish maps of where the rockets landed, and it became evident that the rockets clustered in certain areas, giving the impression that the Germans had achieved technological advances in targeting the rockets well beyond what anyone had thought them capable of doing. Civilians suspected that German spies lived in the neighborhoods not hit by rockets, while British military officials worried that Germany would be able to destroy essential Allied military sites with pinpoint accuracy.¹

After the war, a British statistician named R. D. Clarke published a one-page study showing that despite the clusters the pattern of where the rockets landed was well explained by a random distribution, in other words by chance or luck.² What seemed to be obviously intentional targeting of certain sites when casually viewed on a map was in fact consistent with the laws of probability. Though V-2 accuracy did improve somewhat as the war wound down, in reality the Germans had nowhere near the level of precision feared by panicked London residents and British military officials.³

Figure 1: Randomly Generated Dots Showing Clustering



Source: Comgest. Chart generated using a two-dimensional uniform random variable.

Stress and fear and lack of control over the situation may have made it more likely that the British would jump to unwarranted conclusions, but misinterpreting random data as deterministic is by no means limited to jittery wartime Londoners. In fact, it's been well understood for decades that the human brain frequently recognizes patterns and infers causality in purely random data. Imagine the randomly generated chart shown in Figure 1 were a map of bomb strikes; the clusters and voids are clear to see.

Over time this phenomenon of seeing patterns that aren't really there has been given several names in different domains, such as “apophenia” and “patternicity.” Part of our tendency to jump to conclusions that aren't backed by evidence is due to evolution; back when daily human survival depended on being able to outwit large, nasty predators, the ability to draw inferences from patterns and thus recognize danger was a genuine competitive advantage, and those able to do so were more likely to pass on those abilities to their offspring. The penalty for a false positive –running away when you didn't need to– wasn't nearly as severe as the penalty for

1 Mlodinow, Leonard, “The Drunkard's Walk: How Randomness Rules Our Lives,” Pantheon, 2008, pp. 183-184.
2 Clarke, R. D., “An application of the Poisson distribution,” Journal of the Institute of Actuaries, 72:481, 1946.
3 Mlodinow.

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— **Mistaking noise for signal is endemic in many fields, and financial markets are no exception**

missing a potentially fatal threat. In today’s world, though, the consequence is that our hardwired brains see information in what is really just noise. Mistaking noise for signal is endemic in many fields, and financial markets are no exception.

In this letter I’ll focus on two main points around the idea of randomness and how it relates to investing. First, many people don’t realize the large amount of luck (or noise or randomness) present in the financial markets, especially over short periods of time; and second, well constructed long-term investment strategies can neutralize part of that randomness to deliver results in the long term, but even a good long-term strategy may be no better than chance in the short term.

The less often you look at your investment performance, the better

Let’s say you’ve decided to invest in equities. You can buy a passive exchange-traded fund (ETF) that will track a reference index, or you can invest with an active manager who will try to beat the return of that index. If you go with an active manager, among the parameters you might evaluate are the expected performance advantage for the fund you pick and its tracking error (i.e. the volatility of the relative returns of the fund). Normally the first part – the expected performance advantage – is an area of intense analysis where good fund pickers earn their keep, and the second part, expected tracking error, is predicted using the fund’s history or current positioning. But I’m going to do away with the suspense and just pick numbers for both. Normally, of course, you wouldn’t know them ahead of time.

Imagine a portfolio manager with a strategy that promises to deliver 200 basis points of annualized outperformance versus some index over a long period of time with a tracking error of 4%. (Let’s assume that we have continuous relative returns for this strategy that are normally distributed.⁴) In a world where most active managers show long-term underperformance, this is an attractive strategy indeed – two percentage points of outperformance per year can compound to a large additional increment of wealth, and a tracking error of 4% is well within the range of what many investors would be interested in considering. So, let’s ask a seemingly simple question: Do you think you’d be happy with the relative returns this strategy would generate?

It turns out your happiness with this investment is not going to be that straightforward, **depending on how often you evaluate it**. A 2% average annual return advantage with 4% tracking error translates into outperformance in 69% of the years you invest this way. So, if you only look at your annual brokerage statement, you’ll be happy more than two times out of three. But what if you are really interested in your investment and decide to check it every month? An investment with these characteristics will report positive relative performance in only

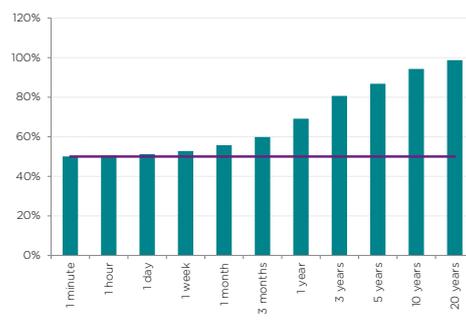
⁴ Assuming normal distributions can be a dangerous thing in equity investing, because equity returns tend to have more observations around the mean as well as fatter tails than those of a normal distribution (i.e. equity returns have a leptokurtic distribution). Here we’re talking about relative, not absolute returns, which mitigates this concern somewhat, and it turns out that using a normal distribution approximation is not a bad assumption for the type of analysis we’ll do.

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56% of the months. You will be much more disappointed in your investment if you see it underperforms nearly half the time you look at it. Now say that you check it every day. In this case you will have just a 51% chance of outperforming in any given day, getting awfully close to a 50/50 coin flip.⁵ You’re probably not going to feel very good at all about this investment, given how often it underperforms. Remember: In most investors’ eyes any long-term outperformance at all is terrific, and here we’re feeling neutral at best with this strategy that guarantees to outperform over long periods of time!⁶

Figure 2: Hypothetical Probability of Outperformance by Investment Horizon



Source: Comgest. The line indicates 50%.

The trend may be apparent, but let’s state it simply: The shorter the time scale over which you evaluate this investment, the less likely it is to outperform. To drive the point home graphically, I’ve plotted a variety of investment holding periods and the probability this strategy outperforms over each time period in Figure 2.

The shorter time periods are more or less the flip of a coin, but even over three years, a standard list evaluation period for many investors, you only have a four-in-five chance of seeing the manager outperform. And remember, you’ve invested with a phenomenal manager in this hypothetical example; most investment managers would be thrilled to be able to guarantee 200 bps of annualized long-term outperformance! Inevitably, many investors are not investing in attractive strategies because they misunderstand the historical track record or are firing managers they already have simply because they invested while the manager experienced a period of bad luck.

What’s going on here? In fact, we’re witnessing investment performance as the combination of two things: 1) The **signal**, or the annualized outperformance that this strategy will deliver over the long run; and 2) The **noise**, or the tracking error, the volatility of relative returns. The first part is deterministic in that we know what its contribution is going to be over any period of time because of how I’ve set up this example. But the second part is random, governed by a probability distribution. We don’t know what its contribution will be in any given period. There will be times where the random part is negative and of a magnitude that overwhelms whatever the deterministic part contributes, and then there will be periods when it’s additive to returns.

The key point, however, is that **lengthening the period of evaluation allows the noise to begin to wash out and the signal to shine through, while for shorter time periods noise dominates**. If the noise component is bigger than the signal component, as in the relative performance example in Figure 2, longer and longer time periods are needed to properly assess the

5 Comgest analysis assuming a continuous distribution of relative returns and based on an example in Taleb, Nassim, “Fooled by Randomness: The Hidden Role of Chance in Life and in the Markets,” Random House, 2005, pp. 64-67.

6 I’ve given this example in relative performance terms, but it’s exactly the same as assuming a 2% return in absolute terms with 4% volatility and determining the percentage of the time the strategy makes money, i.e. has a positive return. To make this more realistic for equity investors, we could assume something on the order of 9% annualized absolute returns with 20% volatility, which is roughly what historical long-term US equity market returns have been. It turns out that the percentages for the various time periods in this case are quite similar to the relative returns example I’ve chosen.

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manager’s ability to outperform. And in fact, in the investing world, this is almost always the case. So, what can we conclude from this analysis? That it’s far less useful to evaluate an investment manager over a short time period, because of the randomness inherent in the markets, but over longer periods of time we have an increasingly good picture of the manager’s skill that may have been obscured by short-term luck, either good or bad. Said differently, luck dominates in the short term, but skill is the determinant in the long term. The issue is recognizing that the randomness inherent in the market means it can take a surprising long time to actually get to the long term. That short-term market movements are attributable to something other than changes in fundamental value is not a new idea – Benjamin Graham, Warren Buffett’s mentor, expressed a related sentiment in his famous line, “In the short run, the market is a voting machine, but in the long run, the market is a weighing machine.”⁷

The root of the problem, of course, is that people don’t want to wait to gather years of data before making a decision to retain or fire a manager, or perhaps they can’t because of institutional imperatives and the pressure inherent in explaining short-term performance to stakeholders. The temptation is therefore to act on short-term data, because investment managers who run public funds typically publish daily performance, and most hedge funds report performance at least monthly. If clients see a couple of poor data points in a row, they start to worry that the manager has “lost his touch.” Well, maybe he has, but you’ll never be able to draw such a conclusion just by looking at a couple months’ worth of returns. Unfortunately, investors have become increasingly short-term focused, and not just since the rise of hedge funds in the 1990s or high frequency trading in the past decade: In 1960 the average holding period for US stocks was more than eight years; by 2010 it was down to six months.⁸

This issue of short-term-ism is far from purely academic, because switching managers has a real cost, first the direct costs of switching, but also because the evidence shows that managers fired for performance reasons tend to outperform the newly hired replacement managers.⁹ Part of this has to do with randomness – if a manager has a stretch of bad performance it may be partly because he is a bad manager, but it’s likely that there was also some bad luck involved. That fired manager is likely to draw less bad luck or may even get good luck the next time around, while the situation may be reversed for the newly hired manager.

7 Interestingly, this exact quote does not appear anywhere in Ben Graham’s published works (at least that I can find), and in his classic book “Security Analysis” Graham writes, “The stock market is a voting machine rather than a weighing machine,” with no reference to the time frame of either situation. Financial journalist Jason Zweig says Warren Buffett is certain Graham repeatedly said the more wellknown version, which is the one Buffett has quoted in his own writing. See www.bogleheads.org/forum/viewtopic.php?t=77840 for more details.

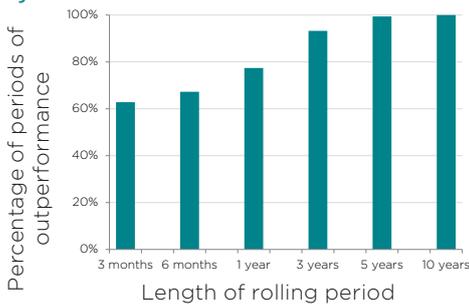
8 Kleintop, Jeffrey, “What the Fed Can’t Do,” LPL Financial Weekly Market Commentary, August 6, 2012.

9 Goyal, Amit, and Sunil Wahal, “The Selection and Termination of Investment Management Firms by Plan Sponsors,” *The Journal of Finance* LXIII, no. 4 (August 2008), pp. 1805-1847.

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Figure 3: Global Emerging Markets Equity Composite Probability of Outperformance by Investment Horizon

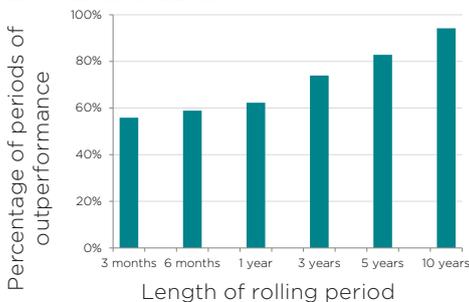


Source: Comgest. Data from Jan. 1995 to Dec. 2013.

Long-term strategies need time to demonstrate their worth

If an investment strategy is genuinely focused on the long term, then logically that investment strategy’s long-term performance should be better than its short-term performance. All Comgest portfolios employ the same “Quality-Growth” investment philosophy and process that involves focusing on business fundamentals and long-term franchise value, which led to the title of this letter. Berkshire Hathaway’s CEO Warren Buffett once wrote, “When we own portions of outstanding businesses with outstanding managements, our favorite holding period is forever,”¹⁰ which is precisely how Comgest approaches portfolio management. Consequently, our portfolios are built with a long-term view that should be good fodder to test this idea. Let’s take a look at some of Comgest’s longest running strategies to see how well they’ve done over varying time periods.

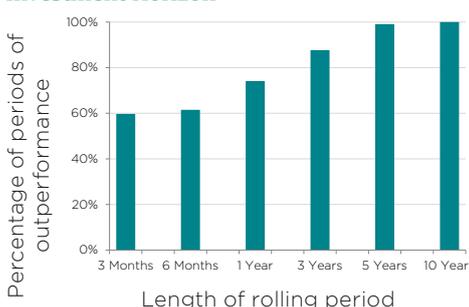
Figure 4: Pan-European Equity Composite Probability of Outperformance by Investment Horizon



Source: Comgest. Data from Sept. 1989 to Dec. 2013.

Figure 3 shows the percentage of given rolling time periods that our Global Emerging Markets Equity composite outperforms its benchmark.^{11,12} The point of an analysis like this is two-fold. First, by using rolling periods, it doesn’t anchor on a specific starting date, and instead looks at the likelihood that an investor sees outperformance when invested for a certain period of time using a random entry date. Indirectly, this addresses the question of whether investors should try to time their entry into Comgest strategies, perhaps waiting for perceived favorable conditions before investing with us. Second, and more importantly, it allows us to see how the strategy tends to perform over various periods of measurement. If what I’m arguing is true, that the long term is not just a collection of short terms, then shorter term performance of a longterm investment strategy can be middling as noise dominates, but long-term investment performance can be excellent, as the signal is given time to penetrate the noise.

Figure 5: Global Equity Composite Probability of Outperformance by Investment Horizon



Source: Comgest. Data from Jul. 1991 to Dec. 2013.

Figures 4 and 5 show the same analysis for our Pan-European Equity composite and Global Equity composite. I’ve selected these three strategies in part because they comprise the vast majority of Comgest’s assets under management, but more so because we’ve been managing these portfolios for a long time, and the longer the track record, the more likely we are to be able to say something meaningful about the ways these strategies behave. Notice that each of these three charts slopes upward from left to right, meaning the likelihood of outperformance increases as investment period increases. This is in fact what we would expect to see from a successful strategy focused on the long-term.

10 Berkshire Hathaway 1988 letter to shareholders (www.berkshirehathaway.com/letters/1988.html).
 11 Performance is stated gross of fees. Management fees for the three Comgest strategies discussed in this letter are charged at 1% per annum within the Comgest Growth plc institutional share classes. Please refer to the Comgest Growth plc prospectus. For details about the relevant indices for each fund, please see the disclosures at the end of this letter.
 12 Details on methodology: I’ve used rolling time periods, measured using calendar months. So, for a rolling three-month window, the first three months of performance history forms one observation, and every subsequent month generates a new observation, as one new month of performance is added and one dropped off. For a rolling five-year window, the first five years (60 months) of data forms one observation, while 61 months of data forms two observations (add a new month of performance, drop the oldest month), and 62 months forms three observations. Consequently, for the chart in Figure 3 that uses the Global Emerging Markets Equity composite performance data from January 1995 to December 2013, a total of 228 months, we have 226 three-month periods, 217 one-year periods, 193 three-year periods, 169 five-year periods, and 109 ten-year periods.

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The rolling three-month outperformance likelihood is not that much above 50% for each of the three portfolios, indicating evaluating a Comgest strategy based on a quarter of data points tells you basically nothing. Our relative performance over the short term is close to a coin toss. But once you lengthen the time period, the odds steadily stack in favor of our strategy. This also means that if you intend to invest long term in a Comgest strategy, timing your subscription is not overly important because our strategies’ longer term performance histories indicate that no matter when you start the measurement period, if you remain invested for the long term, you have had a very good chance of outperforming.

What this says about Comgest’s – and other long-term-focused investment managers’ – investment strategy is that it’s not a good fit for short-term investing, and more specifically, for investors with short-term horizons. We have no idea if we’ll outperform next quarter (and we suspect that even those managers who claim to be able to tell you this don’t actually know it either), but history has shown that investors who hold our funds for long periods of time have had a good experience more often than not. If you’re looking to own an equity fund for the next quarter, our strategies may or may not be the right investment for you. But if you want to invest in equities for the next five years or more, we believe you’re much more likely to walk away happy with your experience investing with us.

— Even though a strategy may outperform over the long term, it will experience shorter periods of underperformance during the stretch of long-term outperformance

There’s another consequence of the shorter bars on the left-hand side of these charts, namely that even though a strategy may outperform over the long term, **it will experience shorter periods of underperformance during the stretch of long-term outperformance.** It turns out that this phenomenon is the rule rather than the exception; top-performing funds over the long term are likely to have sub-periods of underperformance, and sometimes that underperformance is substantial.¹³ When that happens, it’s important for investors to remember that the underperformance may just be a good manager on a streak of bad luck, or it may be evidence that a manager is not as skilled as previously thought, or that something has changed with the manager. Evaluating the manager with this in mind is crucial, since there are direct and implicit costs to switching managers.

Dealing with randomness requires focusing on process over outcome

The obvious question this analysis prompts is: **Why** do these Comgest portfolios have an increasing likelihood of outperformance over longer time periods? I believe the answer is simple. Comgest has a very well defined investment process and sticks to it even during periods when it isn’t working well. This is the classic focus on the **process** by which a decision is made instead of the **outcome** that decision leads to, a technique for maximizing the odds of success in a field where chance plays a large role in what you see happen on a day-to-day basis. This applies in investing, but it also applies in a wide range of other fields, such as card

¹³ Rice, Matthew, and Geoffrey Strotman, “The Next Chapter in the Active versus Passive Debate (2012 Update),” DiMeo Schneider & Associates White Paper, September 2012; and Netzer, Baie, and Melissa Wedel, “Study of Outperforming Managers Reveals Extent to Which They Underperform Along the Way,” Litman Gregory White Paper, September 2006.

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— Over time, focusing on process has a better chance of succeeding than focusing on outcome

games, sporting events, and business;¹⁴ all areas where skill matters, but luck can matter more on any given day. When an outcome involves a component of luck, focusing on what you can control and where you have an advantage—in Comgest’s case, our investment process—will allow your advantage to eventually demonstrate its worth. It just takes time for this to happen. Those who focus on the outcome of an event, rather than the process by which the decision was made, will have their decisions driven by that luck element. Over time, focusing on process has a better chance of succeeding than focusing on outcome. In the moment, though, dispassionately approaching decisions like these is very hard to do. Back to the bombing of London: “In those areas seemingly targeted by the bombs, people moved out, attempting to escape systematic bombing that was in fact not systematic.”¹⁵ The equivalent behavior in the investing world is returns chasing, where a manager posting excellent returns for a period of time sees an avalanche of new money flow into the fund. Returns chasing translates into the average investor in a public equity fund realizing only **half** the return of the average fund;¹⁶ poorly timed entry and exit points are a heavy burden. Whether it’s moving money or moving houses, neither is likely to be a successful strategy over time.

Because of the randomness inherent in investing, we can never say for sure whether past successes (or failures) were due to the investment manager and the manager’s investment process, or simply something outside the manager’s control. Likewise, we can never promise that future results will be satisfactory, even if we know that a manager has proven talent or a superior process, the equivalent of playing with a stacked deck of cards or flipping a coin that favors heads. What we can say, based on both history and theory, is that there are investment managers whose processes appear to give a long-term advantage. In this context, the long term really is more than just a collection of short terms.

14 See for example Lewis, Michael, “Moneyball: The Art of Winning an Unfair Game,” W.W. Norton, 2003; Mauboussin, Michael and Dan Callahan, “Outcome Bias and the Interpreter: How Our Minds Confuse Skill and Luck,” Credit Suisse Investment Research, 15 October 2013; Montier, James, “Value Investing: Tools and Techniques for Intelligent Investment,” Wiley, 2009; and Sklansky, David, “The Theory of Poker: A Professional Poker Player Teaches You How To Think Like One,” Two Plus Two Publishing, 1999.

15 Tierney, John, “See a pattern on Wall Street?” TierneyLab, The New York Times, 3 October, 2008. <http://tierneylab.blogs.nytimes.com/2008/10/03/see-a-pattern-here/>

16 Davis Advisors, “Essential Wisdom for Today’s Market.” www.davisfunds.com/downloads/EW.pdf

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**Peter Shapiro, CFA**
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Peter Shapiro joined Comgest in 2013 and is an Analyst specialised in US equity, contributing to idea generation and management of the Comgest Growth America fund. Peter began his career as an Analyst at Legg Mason Capital Management in Baltimore, Maryland and went on to hold a similar position at a boutique asset manager in Paris. He graduated from Colby College with a Bachelor's Degree in Physics and holds Masters' Degrees in Acoustics from The Pennsylvania State University and Applied and Computational Mathematics from The Johns Hopkins University. He is also a CFA® charterholder.

FOR PROFESSIONAL INVESTORS ONLY

Data in this document is as at 31 December 2013, unless otherwise stated.

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