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Insiders: In it for the long term?

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Intermede's investment approach is focused on identifying businesses that possess durable competitive advantages which drive sustained growth in earnings and cash flows, and ideally offer opportunities for reinvestment of that internally generated capital at high incremental rates of return. Patience, allied with a strict valuation discipline, helps us acquire these businesses at attractive valuations.

One trait sought by our investment team when pursuing such businesses is a high degree of insider ownership. Several decades of cumulative investment experience has led us to regard the presence of owner-managers as a helpfully predictive signal that a business may be better placed to prioritize long term value creation than competitors where an 'owners mentality' does not prevail.

Given that that this is a somewhat qualitative intuition, the aim of this paper is to assess whether the available evidence supports its inclusion among our toolkit of investment criteria.

We have tried to validate the intuition in four ways:

1 Assessing the historical performance of publicly traded global equity securities of businesses with a high degree of internal ownership

2 Examining an illuminating counterfactual by contrasting the investment activities of publicly and privately-owned businesses

3 Assessing the changes in tenure of public company CEOs over time to see if short termism might be a rational response to shrinking service periods

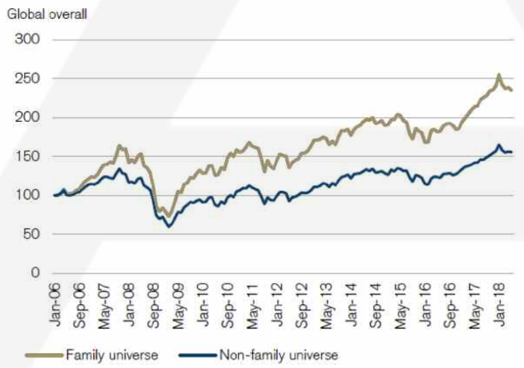
4 Examining survey-based evidence with respect to the decision making of public company CFOs to test whether we are being unfair to deride them as 'short-termist'

Ultimately, we believe our findings support the linked insights that value-destructive short-termism is a widespread problem for public equities, and that a high degree of internal ownership appears to mitigate this risk to a material degree, perhaps providing a helpful tailwind to portfolio performance.

1) Historical performance of 'insider' companies

Examining this question in its most basic form, namely, '*Do companies with high levels of insider ownership tend to outperform their peers?*', the most comprehensive recent work that we have reviewed was published by Credit Suisse in September 2018[1] and showed the global co-

Figure 4: Family-owned companies have outperformed non-family owned companies since 2006



Source: Thomson Reuters, Credit Suisse Research

[1] The CS Family 1000 in 2018', Credit Suisse Research Institute, September 2018

hort of companies with internal ownership (or control of voting rights) greater than 20% achieving a material degree of outperformance since 2006.

2) Investment behaviour of public vs private businesses

The most helpful study of this useful counterfactual that we have reviewed was a study published by NYU Stern business school in 2014[2], which compared the investment behaviour of public and private businesses in the US.

The study's findings were unambiguous, as outlined in the paper's abstract: *"Our results show that compared to private firms, public firms invest substantially less and are less responsive to changes in investment opportunities, especially in industries in which stock prices are most sensitive to earnings news. These findings are consistent with the notion that short-termist pressures distort their investment decisions."*

The magnitude of the difference in behaviour between public and private firms was remarkable: the propensity of private businesses to invest in their own growth was almost *double* that of their public peers.

3) Changing tenure of public company CEOs

The evidence for the likelihood of increased short-termism for public company CEOs was, again, forceful. In the mid-1970s, the average tenure of an S&P500 CEO was approximately a decade. Today it is closer to five years[3]. With their lifespans thus shortened, greater prioritisation by CEOs of the short term could be seen as inevitable.

4) Data from survey of public company CFOs

CFOs also appear to have fallen prey to the same behavioural patterns, with a survey by Duke Business School identifying a tendency to deprioritise long term value in favour of short term gain. When asked whether they would undertake a materially NPV-positive project if it meant an EPS 'miss' of around 4% relative to market consensus, close to half of the CFOs questioned responded that they would reject the project.

Integrating the Insight

We believe this structural short-termism that appears to be widespread among publicly-traded businesses creates opportunities for both investors, and corporate management teams that possess the discipline, farsightedness, and appropriate institutional frameworks to think and behave with longer time horizons in mind.

We therefore prefer, where possible, to invest with management teams that have a true 'owners mentality', which can reduce the risk that investments likely to be beneficial in the long term are avoided in order to prop up short term measures of profitability. Evidence of the absence of this mindset can be found through scrutiny of management incentive plans, which we examine closely for undue emphasis on measures of short term profitability or revenue growth, for example, which can be a helpful red flag, signalling heightened risk of principal-agent problems.

The extent to which this preference is reflected in our global equity portfolios was made clear by the recent report by Credit Suisse[4] referenced above that assessed the long-term investment and operational performance of a global cohort of businesses with elevated levels of insider ownership. At the time of the report's publication, of the top ten largest such businesses as measured by market capitalisation, Intermede's global equity portfolio held seven[5].

2 *Corporate Investment and Stock Market Listing: A Puzzle?*, Asker et. al, NYU Stern, 2014

3 Conference Board, Foster

4 'The CS Family 1000 in 2018', Credit Suisse Research Institute, September 2018

5 These were: Alphabet, Facebook, Alibaba, Samsung Electronics, Oracle, LVMH, Comcast

A small but telling demonstration of long-termism within our own portfolio came during a recent site visit to Eurofins Scientific, a French-listed provider of food, environment and pharmaceutical testing, whose founders retain a 36% equity stake. We met with management in a room in a newly-built testing facility, surrounded on one side by a lawn of freshly laid grass. Eurofins management explained that additional foundations to accommodate the projected future growth of the facilities had been laid at the same time as those for the current building, and that the lawn was simply an aesthetically pleasing way of covering these. This pre-emptive construction took advantage of economies of scale to reduce materials and labour costs, and to extract maximum future value from a single planning process. Such forward thinking will reduce near term earnings, but will be accretive to long term value, and is therefore indicative of the long term mindset that causes us to admire Eurofins's insider management team.

Another exemplary long-termist business from the current portfolio is Charles Schwab, the US-listed discount brokerage firm, the eponymous founder of which remains the largest shareholder, with an 11% stake. We are impressed by the consistency with which Schwab has prioritised the needs of its clients, rather than maximising short term revenues, as reflected in Schwab's industry-leading policy of continuous fee reductions as a means of sharing the benefits of scale with their customers.

Conclusion – A Dual Source of Investment Advantage?

As investors, perhaps the most satisfying aspect of prioritising long-termist businesses in our clients' portfolios lies in the fact that the equity market frequently judges such farsightedness harshly, punishing any dip in short term earnings with a decline in share price, providing us with a bargain entry point at a moment at which the intrinsic value of the business has arguably just increased.

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