14th BIS Annual Conference – June 26 2015- Lucerne
Session 2: Investor Behaviour and the Wider Economy

Discussion of Andrei Schleifer et al., Expectations and Investment
By Philipp Hildebrand, Vice Chairman of BlackRock

- This is a "very cool" paper, raising deeper questions than may appear at first sight. Perhaps most excitingly, it offers a way to predict firm investment, a quest that was at the heart of a very heated research paper-based controversy in the 1990s between Glenn Hubbard and Luigi Zingales.[1]

- This is not just a matter of academic interest, but also one that has potentially significant policy implications. It has in fact been a big puzzle in recent years why capex has been so low despite record low interest rates and ample cash reserves—and instead we are seeing in the US financial spending (share buy-backs and M&As) amounting to nearly 100% of operating cash flow. Well, earnings expectations have been relatively depressed, and so as the paper predicts, capex has been depressed. But it is also the case that firms have often preferred to engage in share buybacks to give a short term boost to earnings. That is almost certainly bad for long term returns.

- I see three key take-aways from the paper:
  1. Contrary to standard macro theory, earnings expectations, as measured by surveys, matter--both for stock-market valuations, and for investment decisions;
  2. Analysts and CFO earnings expectations are extrapolative and usually wrong;
  3. Higher investment actually leads to lower returns over a 12 months horizon.

- I generally agree with the findings, although a quibble might be that the results might be unduly affected by the impact on returns of the global financial crisis. Will share some comments on these 3 take-aways and outline the implications for an investment firm.

1. Measured expectations matter for both investment decisions and stock valuations

  - This runs contrary to what rational expectations theory would suggest; that in itself is not terribly surprising, but it is worth noting because of course, for lack of a superior alternative, many macro models still use that approach to modelling expectations,).

  - This discrepancy between the reality of how financial decisions are made and how macro models are built illustrates that, sadly, there is still a long way to go in welding together financial and macroeconomic thinking. But this paper is clearly a useful step, or set of steps, on that path and, along with the efforts deployed for several years

[1] Hubbard and his co-authors claimed they could forecast investment using the lens of "financial constraints." Kaplan and Zingales took the same data, looked carefully and stated that none of the results held. (There was also a reply and a reply to the reply). A consequence of that debate was massive retrenchment of researchers into the ivory tower (more precisely, into the estimation of complicated structural models somewhat losing sight of reality.

already by the IMF, it is very much to the BIS credit to keep pushing in this direction. None better than Hyun Shin and Claudio Borio could lead this effort.

2. Analysts and CFOs' earnings expectations are usually wrong

- This is actually a well-known phenomenon in the investment community. We even use signals based on them, particularly in our systematic investment activities: when earnings expectations are high, we know it is time to sell (with some variations depending on the phase of the cycle we are in> when getting near the top of the cycle, high earnings portend bad days ahead, and vice-versa when getting near the trough of a downturn).

- What is interesting is that in our empirical research underpinning our investment strategies, we find that not all expectations suffer from this problem; for example purchasing manager surveys indices (PMIs) or lending officer surveys, are usually quite reliable to predict turns in the business cycle. And even CFOs are a valuable source of information when it comes to other things than earnings forecasts. What accounts for this difference in forecast performance?

    - Analyst and CFO earnings forecasts are more likely to be contaminated by bias;
    - They do not reflect a hands-on upstream grasp of economic activity;
    - They tend to be firm-centric and lack a broad perspective.

- In the very short term however, given the prevalence of so-called momentum strategies, earnings expectations are a relevant indicator—but essentially as a gauge of market sentiment.

3. Higher investment is correlated with lower returns

- This is completely counter-intuitive but sadly not a data fluke. In fact it is another kind of law of nature that is familiar to investment professionals: high capex is an almost fool-proof predictor of lower returns, at least over the short to medium-term horizon most investors care about.

- What is going on here? Literally this means that what investment does take place is not very good at generating growth, i.e., there is a very material misallocation of resources—why? Because investment decisions are driven by backward looking, extrapolative earnings expectations. This is in fact a recipe for chronic over-investment in sectors with high momentum and under-investment in sectors with low momentum—consistent with the facts on the ground.

- A potentially very adverse implication for long term growth is that such market dynamics de facto discourage capex, including the genuinely growth-enhancing type. It is perhaps no coincidence that private companies and companies with high family ownership tend to outperform—because they can take a longer view to returns.

- This leads us to the debate over how to promote long-termism from corporate CEOs and whether excessively short stock holding periods—in other words short-termism by stock investors—is to blame. Conventional wisdom, backed by some data, is that stock holding periods have shortened dramatically in recent decades. This actually seems worth investigating further. In recent years there has been a shift towards index-based investing—now 90 percent of our AUM invested in equities[2]—a model under which a stock is held for as long as it remains part of the index. But there has also been a rise of high frequency trading. So it may be that some stock holders have very short holding periods, but it is not clear they dominate the market in volume terms.

- Is there a need to do more and incentivize long term stock holding with differentiated voting rights, as under new French legislation and considered more broadly at the EU level? We actually think this would be counterproductive. In fact evidence on earning of firms with such regimes suggests they do not perform as well as those that apply a "one share, one vote" regime—possibly because they tend to have worse corporate governance across the board. Much more important would be to refocus performance analysis and rewards to the longer term.

~~/~~

- To conclude, what does a large asset manager like BLK make of all this?

  As far as our investment processes go, we are moving in two directions:

  - For the top-down part, macro-factor investing, and area on which we are putting increasing emphasis; in fact we just hired Professor Andrew Ang to help us spearhead this effort: basically, since we cannot really predict returns, we focus instead on the underlying fundamental factors driving the returns, such as economic growth or real rates; this allows us to make sure that our risk exposures are fundamentally balanced; this isn't mainstreamed yet but definitely the direction of travel;

  - For the bottom-up part, rather than looking at earnings expectations we seek to identify genuinely good growth—in the balance sheets, in the cash flows for instance. Although admittedly we have not found such signals to identify "good" investment. For that, nothing beats a long track record of good return on equity.

  - Both types of investment processes are increasingly informed by the use of big data, for example using machine-learning to skim through the 6000+ analysts reports we receive every day in multiple languages, tracking patterns of consumer searches for durable goods on the internet (based on this we correctly forecasted the 2013 turnaround in the Spanish economy and the US slowdown in Q1 of this year; or using software to read online commentary to gain insight on employee attitudes toward their firm, a strong indicator of future performance.

[2] For the entire industry of externally managed assets, index-based equities represent only a third of total AUM. We do not know to what extent internally managed assets follow such strategies.

Finally, we as a shareholder try to engage directly with CEOs to push them to focus explicitly and demonstrably on long term performance and value generation.