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A holistic search for ways to beat the market

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THE LONG VIEW

Fund management is increasingly resembling a headlong dash for short-term gains; the overpaid in pursuit of the ephemeral. The average US mutual fund turns over its portfolio once every 10 months.

Such a turnover rate is a lot closer to speculating than it is to investing. One sometimes gets the feeling that investors do not care what the company does, or even what its name is, providing its share price is going up over the next month or so.

But is it possible to take a longer-term view? And does it make sense to look at broader factors than whether a company meets its next quarterly earnings per share forecast?

A new fund management company, launched this week, believes it is. Generation Investment Management has been founded by a group of managers, largely drawn from Goldman Sachs Asset Management, and backed by the political clout of former US vice-president Al Gore.

Generation will specialise in "sustainable" investment management, but is keen to emphasise that this is not a touchy-feely, "new age" approach. The idea is that the long-term prospects for companies are affected by a host of intangible factors. Some of these will include social issues such as the environment. But they also feature subjects such as corporate governance, brand management, personnel relations and geopolitics.

The idea is that the excessive focus on the short-term by traditional investors creates profitable opportunities for those who can take a longer perspective. An example is the motor industry, where Gore says China has adopted environmental standards more onerous than those in the US. Over the long run, it makes sense to own the shares of companies that have shown the ability to adapt to harsher standards, such as Toyota, rather than companies, for example Ford, that are dependent on areas such as heavy trucks.

Other companies have suffered from the effects of litigation (tobacco), from consumer reaction to labour practices in the third world (footwear manufacturers) or from climate change (insurance companies). These are all factors that will not be covered by traditional investment analysis.

Corporate governance may seem like a bureaucratic box-ticking exercise. Are the chairman and chief executive different people? Check. Is there a majority of non-executives on the board? Check. But if the company is not open and transparent with shareholders, they need to be suspicious. Just ask investors in Enron.

Generation is part of the Enhanced Analytics Initiative, a group of investors that has pressed the brokerage community for more coverage of intangible factors such as corporate governance (others include PGGM, the Dutch pension fund, the Universities Superannuation Scheme, BNP Paribas Asset Management and RCM, the fund management group). The group has pledged to devote 5 per cent of its commission income to encouraging broker research on these topics.

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The company says it is dedicated to long-term investing and will accordingly rely for the bulk of its profits on performance fees, with performance measured over a minimum of three years. The aim is to align the interests of the managers with those of the investors.

Many people will be cynical about this kind of development. They will point to the limited investment successes of ethical funds, which exclude on principle certain stock market sectors such as tobacco, alcohol and arms manufacture.

Generation says its approach is not the same as an ethical fund because it will focus on finding companies that can benefit from intangible factors, rather than on eliminating whole categories of companies. It will run a highly concentrated portfolio – 30 to 50 stocks – and will aim for annual returns in the double digits.

The company's initial problem is that it does not really have any performance data to back up its claims; studies that have looked at the success of sustainable investment have been ambivalent. Its strongest appeal is in the calibre of the staff it has recruited – you don't progress far at Goldman Sachs by hugging trees and eating quiche.

Furthermore, there is a potential gap in the way that companies are analysed and researched. Investment bank analysts and fund managers find it hard to see the wood for the trees. They concentrate heavily on the immediate outlook for earnings (understandably, because these are easiest to forecast) and punish any company that falls short of expectations. Many investors use momentum-based strategies or chart-based approaches that focus on the recent movement of the share price rather than the underlying health of the company.

Research on the longer-term issues highlighted by Generation is often not done, largely because investors have been unwilling to pay for it. "Paying an upfront cost, to meet an uncertain demand for a new product that is not aligned to their transactions-based business model has proved too high an obstacle for brokers," says Professor Avinash Persaud, chairman of Intelligence Capital, a financial advisory company.

This very lack of research may give an advantage to firms such as Generation, which aims to integrate sustainability issues into its internal investment process. If an area is under-researched, prices may be set at an inefficient level, creating the opportunity for profit.

The problem for Generation and others that may follow this route is that, as Keynes said, "the markets can be irrational longer than you can remain solvent". Even if the factors analysed by Generation do affect corporate performance, that effect could show up only over the very long run. Clients may need to be patient. If, after the first three years, Generation has not beaten its benchmark, will clients stay? Will key staff stay, without the cushion of performance fees?

But it must be a welcome development that someone is making the effort to find a new way of beating the market. The current fashion for frantic activity looks like a dead end.

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