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Education

Behavioural finance: Short termism

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At the start of a new year, investors tend to ponder the prospects for the subsequent 12 months. It says something of how short term the focus in markets has become that this may be one of the relatively few occasions when many investors even think that far ahead. Such short termism, however, is at odds with building long-term portfolio wealth.

But it turns out that investors are hard-wired for short termism. In experiments, investors routinely value short-term gains more than they value delayed benefits. The culprit here is dopamine, a feel-good chemical that our brains release when faced with a short-term reward. In fact, the possibility of imminent monetary reward has been shown to trigger dopamine release in much the same way as food and alcohol can.

Neuroscientists have shown that different parts of the brain are responsible for valuing short- and long-term monetary payoffs. Behavioural studies show most people would take $100 today over $200 in a year’s time, but would not take $100 in six years over $200 in seven. There is no rational reason for this inconsistency; the trade-offs are identical in monetary terms.

The problem of short termism in stock markets runs deeper than just investors. It is part and parcel of how stock markets function due to the way in which future company earnings are valued by the investment industry. The issue here is that most sell-side analysts focus heavily on short-term earnings projections over the next one to three years.

So, how should investors go about beating the market? One approach is simply to take a longer view than the majority. Given the greater short-term focus of investors and sell-side analysts, the equity market has become relatively effective at pricing near-term earnings expectations where there tends to be greater certainty. However, the market is less effective at evaluating longer-term earnings, showing a relative neglect for the longer-term value of companies exposed to strong structural growth. This represents an opportunity for investors and investment strategies that can sensibly identify structural growth winners.

Exposure to structural growth allows a company to generate a steady stream of cash that can be reinvested into a growing business. It is the ability of these companies to reinvest that cash into the strong growth opportunities that provides the compounding engine for sustained, long-term growth in their earnings. And, this is where an understanding of longer-term drivers and trends such as demographics can be particularly useful in informing the investment process.

Short termism may be rife in equity markets, but the evidence suggests investors can use this to their advantage by taking a long-term view and investing in those strategies that are designed to do likewise.

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