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Investment Horizon: Its Definition Has To Be Flexible—And Possibly Shorter

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Investors and the investment industry have received frequent criticism related to the average holding period of securities and mutual funds. It has been noted that the turnover of many investment funds has been quite high in recent years relative to history, and very high in absolute terms. For example, John Bogle, founder and former chairman of the Vanguard Group, noted that the turnover on the average fund had increased from 15-20 percent per annum 50 years ago to about 90 percent today, and the annual turnover of the NASDAQ is around 275 percent (1). In addition he noted that fund investors held their funds about 12.5 years back then, now a little over two years (1). Even though the market decline since the summer of 2000 may have somewhat tempered the above statistics, it is likely only temporary. It was sometimes argued in the past that one's investment horizon should span one's working career, which could range from ages 25-65, or as long as 40 years, and decline in span as one approached retirement.

When viewed in isolation, it has sometimes been characterized that many investors and fund managers are more speculative these days, looking for the quick buck, and no longer thinking long-term. the dramatic increase in turnover has been cited as a danger sign for the long-term health of the stock market and the world economy. The booming and speculative stock market era of the 1920s is sometimes put forward as a negative example of a phenomenon similar to what we have seen recently. Even though there may be some truth in these claims, it is not the whole story.

Arguing about the appropriate number of years that one should include in an investment horizon can be tricky, and possibly foolish. We should note that there have been a number of fundamental changes in the marketplace that have in large part caused this high turnover and short-horizon mindset to have taken place:

- **Changes in global economics due to technology and innovation.**
  The ability of a company to dominate its industry is less assured than it ever was. Through faster innovation, better product design, and better management, another company can displace a leader more easily than it could decades ago. Products become obsolete in a shorter amount of time. Therefore, holding onto a stock in a portfolio too long, without understanding the changing economic dynamics underlying the business that the stock represents can be detrimental.

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- **Access to corporate information.**
  Today's individual investors have easy access to all sorts of information through such tools as the Internet. Decades ago, such information was mainly under the domain (and protection) of Wall Street firms and their international counterparts. Even then, Wall Street firms may have had to wait weeks to receive certain reports. In turn, investors often had to wait even longer for information on which to base a new trade. Almost anyone can obtain much of the same information as professional firms do these days. Due to the quantity ("explosion") of information, only certain securities may be followed by Wall Street, so the smaller investor can research companies that would never reach the attention of the big investment houses.

- **Significantly lower commissions.**
  It is now much cheaper to trade stocks than it was only a decade ago. In the 1980s it could cost approximately on-three percent commission each way (often determined on share price and block size) to trade blue chips. By necessity, one would often need to stay in the security for several months just to break even. Today, commissions are very low, and depending on volatility one can cover these costs in a few minutes or hours. Hence, it is much easier to get-in and get-out with a profit than it once was. This, and the expansion of futures trading, have helped foster the day-trading industry.

- **Falling bid-ask spreads.**
  Globalization has helped foster more trading and hence more volume on local markets, which allows for more liquidity. With greater market liquidity and activity, spreads have narrowed, causing less slippage. It is therefore much easier for one to enter or exit a position at a desired price, and hence, preserve a profit.

- **Access to trading technology.**
  Investors can now place a trade with out the need for a visible middleman to take the order, and can even

approach the market floor more directly. The investor has access to quotes (even for futures) without the need to call a broker. In addition, the investor can access (and even develop) trading systems that are as good as, or even better, than what the broker may have. The entire trading process is easier and isno longer outside of the small investor's grasp. Ironically, individual investors can even exit positions ahead of their broker or fund manager through this technology, having smaller positions and through the use of competition.

- **The decline in interest rates and competing vehicles.**
  With the decline in the rate of return earned through vehicles such as bonds, more investors and portfolio managers have been drawn into the stock market than once was the case, simply in order to achieve the same returns they once enjoyed from fixed-income securities. In the 1980s, it was quite easy to achieve a rate of return over 10% in the bond market, especially if the bond was held to maturity. Real estate has also not been as exciting as it once was in past episodes of inflation. This asset class migration has not only resulted in more stock market activity, but in higher turnover, as fund managers continue to maintain their desire for high or double-digit returns which (on the surface at least) appeared easier to achieve in the equity market. This mindset for high or double-digit returns may still not have been broken.

- **Broker competition.**
  There is greater competition for order flow due to the decline in the items identified above. Hence there is more incentive to attract investors via inducements such as lower cost, better trading platforms, and online research. This in turn, perpetuates the cycle of declining commissions, better information access, better technology, innovation, access to quotes, etc.

Some of the negatives that have produced higher turnover include the following:

- **Stronger "irrational" emphasis or expectations on short-term results of fund managers and companies.**
  Despite the "academic" emphasis on firms to invest in research and development and for fund managers to have a longer-term view of company prospects and profitability, there is still undue pressure on short-term performance. Individual investors have had high expectations, and there are many professionally managed funds competing for the same clientele

- **Better investor education.**
  Investors and the public know and understand the stock market better than they used to. This does not mean that they are better investors, but rather, that they think they are better investors. This encourages more of the public to enter the stock market with less fear, and to take risks, gamble, and speculate. This also increases trading activity. They may be even more inclined to enter the market "leveraged," or in personal debt.

- **Exceptional equity returns during the past two decades.**
  This had produced a mentality that everyone can win via the stock market, and hence, equity investing and trading can always yield a profit given time and patience. This led to greater stock ownership by the public than at any other time in history. The market decline of the past two years has probably tempered that view, but then again, memories are short so a few years of good returns can once again make people forget the pain of any bad investment years.

Despite the negatives cited above, the overall evolution in the trading environment has produced a situation where investment horizons have had to be shortened. Corporate product cycles are quicker; market entry and exit is cheaper, easier, and simpler; corporate dominance is less secure; and the pace of technological advances allows for greater corporate evolution and change.

The notion of investment horizon should have never been viewed as a fixed period of time. In the 1800s, investing in the railroads may have been one of the best bets of the century. In the 1900s, the car industry may have had its dominance, but only for half of the century. Then came large mainframe computers that dominated for about one quarter of the century. Then came the personal computer market that dominated for much of the past 15 years. The cell phone market and related products may has dominated for the past seven years. Now we have innovations and new industries that may run their course in only a few years—until something new comes along. We must realize that to hold onto something for the long-term is only valid if we continue to revise and often slide down our definition of what long-term is, given the dynamics of the industries and the economics that we currently see. Otherwise a static investment portfolio will not remain static in terms of value, but may rise for only a short while, and then decline precipitously.

Reference: Bogle, John. Vanguard Founder. Interview. *Streetside Chat* *December 2, 2000.*

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