



Inside the investment team...

The economic costs of excessive short-termism

At this year's Portfolio Construction conference in Sydney (25-28 August), Hyperion received the Editor's Pick Award from a total of 32 initial submissions for its research paper 'The Economic Costs of Excessive Short-termism.'

Co-authored by Hyperion's Chief Investment Officer, Mark Arnold, and Portfolio Manager, Jason Orthman, the paper condemns the increasing trend toward short-term thinking, planning and measurement by key industry agents, including corporate management, active fund managers, asset consultants, super fund trustees and 'mum and dad' investors. Arnold and Orthman also shed light on potential reasons for the excessive focus on the short-term we see in investing today.

Here, the authors give an overview of how and why a focus on short-term gratification is distorting the behaviour of companies, markets and investors – leading to impaired financial performance and, ultimately, significant losses to investors.

Short-termism under the spotlight

Despite the fact that the dangers of short-termism have been recognised for decades (Keynes, among others, published on the concepts more than 75 years ago), there continues to be significant and increasing evidence of short-termism in the market today, including:

- the trend from long-term fundamental based investing to short-term trading;
- index "hugging" by fund managers;
- corporate managers' focus on achieving short-term EPS and DPS growth targets, potentially at the expense of long-term growth; and
- super fund trustees' and individual investors' focus on short-term investment performance in determining whether to hire and fire fund managers.

Indeed, in Hyperion's view, short-termism has reached epidemic proportions among the investment industry – with individual investors, most of whom have a long-term investment horizon, paying the price.

Pre-disposed to short-termism?

Humans have an inherent focus on the short-term. Behavioural finance research indicates that it is human nature to have a preference for short-term activity and outcomes, and for factors such as emotion to influence investment decision making.

People tend to over-emphasise the importance of **recent events**. This bias often results in investors projecting current conditions and recent trends into the future when making forecasts, even when the current economic and financial conditions are very unlikely to represent "normalised" conditions in the long-term.

People like immediacy and gratification and prefer positive **outcomes** to occur sooner rather than later. People like to track progress in the smallest time segments as is practicable. We tend to prefer more information to less because it makes us feel like we are better prepared to make decisions, even if the information is unlikely to improve the quality of the decision (Gray, 2006).

We tend to be **overconfident** regarding our ability to correctly predict future events. In *Irrational Exuberance*, Shiller refers to a 1996 survey where 40% and 50% of participants, respectively, believed they could effectively time an individual stock or managed fund investment decision, but only 11% believed they could time the market.

Humans like **short cuts** and there are many examples in financial markets. Managers and investors place undue emphasis on periodic (quarterly) earnings, in part, as a simple metric that captures corporate performance. People believe it is more efficient to get rich quick rather than having to wait many years. Decisions are heavily influenced by emotional factors such as **fear, greed, impatience and regret**.

Potential solutions ahead

Ultimately, the vast majority of agents in the investment industry need to re-focus their thinking from short-term to long-term horizons.

In Hyperion's view, as most investors and super fund members' main objective for investing their savings is to have sufficient savings for retirement, trustees' and investment managers' decisions should be based on the key factors that drive long-term investment returns – not the short-term vagaries of the market.

Agent-specific solutions include:

- **For corporate management:** setting long-term strategic goals, ceasing short-term earnings guidance and changing remuneration structures from short-term earnings to long-term sustainable value accretion for equity holders.
- **For active fund managers:** extending performance measurement to five years or more, payment of annual bonuses on the basis of rolling medium to longer term performance and the requirement for portfolio managers to make meaningful investments in the fund.
- **For mum and dad investors:** super fund investors need to lengthen time periods in which they provide reports and focus their commentary on the long-term returns achieved by the fund and relevant benchmarks, as well as providing realistic and fundamental based long-term return estimates.

A full version of the research paper can be found on our website at <http://www.hyperionam.com.au/news2.php>

Strong reporting season results bode well for EPS growth

Overall it was a strong reporting season for the portfolio with portfolio weighted EPS growth of 21% and DPS growth of 14%. We expect double digit EPS growth to continue for the portfolio over the next five years. Strong earnings together with attractive valuation levels should produce extremely attractive 5-year returns.

Quality internet companies continue to perform

Both the Hyperion Australian Equities Composite and the Hyperion Australian Equities ASX 300 Composite outperformed the market during August. The Hyperion Australian Equities composite returned -1.27% and the Hyperion Australian Equities ASX 300 composite returned -1.78% versus the S&P/ASX 300 Accumulation index return of -1.98%.

For the Hyperion Australian Equities Composite the largest positive contribution to active performance came from the portfolio's investments in Cochlear (8.57%), Carsales.com (8.26%) and REA Group (8.20%). The largest detractors from active performance during the month included SEEK (-15.11%), not owning Wesfarmers (7.91%) or Telstra Corporation (6.11%).

For the Hyperion Australian Equities ASX 300 Composite, the largest positive contribution to active performance came from the portfolio's investments in Cochlear (8.57%), Carsales.com (8.26%) and REA Group (8.20%). The largest detractors from active performance included SEEK (-15.11%), not owning Wesfarmers (7.91%) and our overweight position in Rio Tinto (-8.73%).

Carsales.com posted a solid result during the month. The company grew earnings by 34% year on year, following an increase in revenues of 24%. The increase in revenue was driven by solid growth across all major business lines - car dealer revenue rose 16%, private seller revenue increased 36%, display advertising was up 51% and management services grew 23%. Carsales.com continued to grow enquiry volumes from both the dealer channel (11%) and from private sellers (15%). The company maintained the cost per lead of \$35 for the dealers and increased the cost for private sellers by \$10 to \$60. Strong cash flow generation was again a feature of the Carsales.com result.

Seek produced a strong result with both revenue and profit growth of approximately 20%. The largest contributor to profit was the Australian employment classifieds business which again outgrew competitors. With only 52% of employment advertising in Australia spent online there is further significant revenue growth potential. International investments contributed \$17m to net profit (up from \$2m pcp) as the businesses began to reach critical mass in their respective markets. Seek's education business continues to be a drag on profit but is now a small component of the overall group. The Seek share price has been under pressure of late due to concerns that the domestic unemployment rate will increase over the next 12 months. We view this short-term head wind as an opportunity to acquire more of a high quality company at an attractive price.

Performance	1 mth	6 mth	1 year	2 year	5 year	Since inception (Oct 96)
Hyperion Australian Equities Composite	-1.27	-8.70	-0.78	1.99	3.95	13.37
Excess Performance over S&P/ASX 300 Accumulation Index	0.71	0.45	-2.85	-0.08	3.10	4.74

Hyperion Australian Equities Composite Top 10 Stock Holdings

Stock	Absolute Weight (%)	Active Weight (%)
Cochlear	7.41	7.00
BHP Billiton	7.34	-4.81
Seek	6.73	6.56
Rio Tinto	6.36	3.35
Commonwealth Bank of Australia	6.16	-1.00
Sky Network Television	5.34	5.34
WorleyParsons	5.05	4.52
ANZ	4.35	-0.72
REA Group	4.35	4.28
Carsales.com	4.33	4.23

Performance	1 mth	6 mth	1 year	2 year	5 year	Since inception (May 03)
Hyperion Australian Equities ASX 300 Composite	-1.78	-9.87	-1.48	0.50	5.04	13.20
Excess Performance over S&P/ASX 300 Accumulation Index	0.20	-0.72	-3.55	-1.57	4.20	4.22

Hyperion Australian Equities ASX 300 Composite Top 10 Stock Holdings

Stock	Absolute Weight (%)	Active Weight (%)
BHP Billiton	8.68	-3.47
Cochlear	8.50	8.10
Rio Tinto	7.78	4.77
Seek	7.26	7.09
Commonwealth Bank of Australia	6.38	-0.77
WorleyParsons	6.37	5.83
AMP	5.89	4.68
ANZ	5.40	0.33
Woolworths	5.05	2.12
Platinum Asset Management	4.21	4.12

Count Financial's growth prospects acknowledged in takeover bid

The Hyperion Small Growth Companies Fund performed strongly during the month. The portfolio returned 5.04% versus the S&P/ASX Small Ordinaries Accumulation Index return -2.69%. The biggest contribution to the portfolio's return during the month came from the position in Count Financial (28.24%), with Carsales.com (8.26%) and Domino's Pizza (21.03%) also adding significant value to the portfolio. The largest detractors from active performance Wotif.com Holdings (-6.74%), IRESS Market Technology (-6.13%) and Reckon (-7.16%).

Count Financial's share price was boosted by a \$1.44 cash or share offer from Commonwealth Bank of Australia (CBA). CBA identified that Count Financial was a high quality niche provider of financial planning services for accountants with good long-term growth prospects. We are in no rush to accept the takeover bid and hope that the quality attributes of Count Financial, identified by Hyperion and CBA, are attractive to other acquisitive financial service providers.

Performance	1 mth	6 mth	1 year	2 year	5 year	Since inception (Oct 02)
High Conviction Small Growth Companies Portfolio	5.04	0.78	10.57	10.06	9.37	25.28
Excess Performance over S&P/ASX Small Ords Accumulation Index	7.73	11.53	3.33	5.12	9.07	15.53

High Conviction Small Growth Companies Portfolio Top 10 Stock Holdings		
Stock	Absolute Weight (%)	Active Weight (%)
Sky Network Television	9.46	9.46
Count Financial	9.16	9.16
REA Group	9.00	8.31
Carsales.com	8.88	7.83
Platinum Asset Management	8.32	7.38
IRESS Market Technology	7.51	6.71
Wotif.com Holdings	6.99	6.49
Dominos Pizza	5.62	5.62
Reckon	5.22	5.22
Navitas	4.56	3.79

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