Sarah Williamson is the CEO of FCLTGlobal, a non-profit consortium of large asset managers, allocators, and corporations dedicated to encouraging long-term behavior in business and investment decision-making. FCLTGlobal conducts research, convenes business leaders, develops actionable tools, and generates broad awareness of ways in which a longer-term focus can increase innovation, economic growth, and future savings.

Prior to joining FCLTGlobal in 2016, Sarah spent 21 years at Wellington Management Company, where she was most recently a Partner and Director of Alternative Investments. She started her career at Goldman Sachs, and had stints at the U.S. Department of State and McKinsey before joining Wellington. Our conversation beings with Sarah’s career and turns to FCLTGlobal. We talk about potential improvements at the corporate level, including eliminating quarterly guidance, executive compensation, capital allocation, and Board dynamics, and then turn to the relationship between money managers and allocators, including fee structures, setting expectations, reporting returns, and governance. Lastly, Sarah discusses new research initiatives.

Edited by: Rev.com
Hello. I'm Ted Seides, and this is Capital Allocators. This show is an open exploration of the people and process behind capital allocation. Through conversations with leaders in the money game, we learn how these holders of the keys to the kingdom allocate their time and their capital. You can keep up to date by visiting capitalallocatorspodcast.com. My guest on today’s show is Sarah Williamson, the CEO of FCLT Global, a non-profit consortium of large asset managers, allocators, and corporations dedicated to encouraging long-term behavior in business and investment decision making. FCLT Global conducts research, convenes business leaders, develops actionable tools, and generates broad awareness in ways in which a longer term focus can increase innovation, economic growth, and future savings.

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Lastly, we hear about FCLT Global's new research initiatives. I'm pulling for Sarah and FCLT. If their work bears fruit, we will all be better off, and most importantly, so will our clients.

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Ted: 02:42 Please enjoy my conversation with Sarah Williamson.

Ted: 02:48 Sarah, thanks so much for joining me.

Sarah: 02:50 It's my pleasure, thank you.

Ted: 02:52 I'm excited to have this conversation. As always, I love starting with someone's history, so why don't you dive right in?

Sarah: 02:59 All right, I'll give you a little bit of history. I've been in the investment business for a long time, but I grew up in a very academic family. Nobody in my family is in business for several generations.

Ted: 03:10 What'd your folks do?

Sarah: 03:10 They teach international relations and political philosophy and small children to read and all of those sorts of things.

Sarah: 03:19 So I went to Williams, but when I was graduating, I was an econ major. I needed a job, and I didn't know much about the world of finance, but I interviewed through Williams and, surprisingly enough, got a call back to go to Goldman Sachs in the mergers department. I think I have a history of being offered jobs I wasn't really qualified for. That was one where I remember they were asking me the classic, "What's your weakness?" And I actually said, "Well, I've never taken an accounting course." And they were quite surprised that, first of all, that was true, and that I admitted it. But I went to Goldman Sachs, I worked in the mergers department. That was the early 80s, so it was an interesting place at that time. It was a bit of a locker room. But I did that for a year in New York and then a year in London.

Sarah: 04:01 I was young when I graduated from college. I had gotten into business school, and I was planning to go. But I thought about doing what today we might call a gap year, so I went to John Whitehead, who at the time was co-chairman of Goldman Sachs, to ask him for some career advice, which seemed like a logical thing to do for a 21 year old. He said he was going to Washington to be the deputy Secretary of State and asked if I would like to come. So I said sure. I tagged along with John Whitehead to Washington, and I did that for a year. Then I went to business school at Harvard. Went to McKinsey, first in London, and then in Dallas, and then in Boston for five years. And then I went to Wellington. So I went to Wellington
Management in Boston and I was there for 21 and a half years. Mostly in Boston, also over in the San Francisco office came back, so spent a lot of time on the buy-side.

Ted: 04:49 And what was your path at Wellington?

Sarah: 04:51 I started in Boston working with endowments and foundations. Again, I don't think I was qualified for that job either. But I had known some people who had moved from McKinsey to Wellington, and so my first job was trying to figure out how Wellington could do a better job managing money for endowments. Wellington had managed money for MIT for years, but the rest of the business with endowments was quite small, so the job was understanding that community, making sure we had products that made sense for that community, and spending a lot of time with the endowment and foundation.

Ted: 05:24 And what'd you find?

Sarah: 05:24 What I found is that, as you know, they're very different investors than pension plans. They are not pension plans, they tend to be much longer term. They tend to be more interested in total return than other issues, like fitting things in boxes, and some things that some other investors have to worry more about. They tended to be some of the most sophisticated and interesting and challenging clients, so they were often on the leading edge, which was always fun.

Ted: 05:49 Were you able to take what existed at Wellington and either change it or change a product to address that group of potential investors?

Sarah: 05:58 Yes, yeah. So I mean, for example, at that time, Wellington had a very strong energy team for years. Managed a lot of energy money for years.

Ted: 06:06 Ernst von Metzsch.

Sarah: 06:08 Ernst von Metzsch, yes, exactly. In the public markets. And there were a number of endowments, particularly then, that were trying to figure out inflation hedges. And so, energy is a logical inflation hedge in a lot of ways, and that made sense. But then that also, then, transformed into broader inflation hedge products. And that was something that, particularly at that time, the endowment community was particularly interested in,
most of the other parts of the investing world were not. So that was an example of trying to take the pieces of a puzzle and put them together in a different way.

Ted: 06:34 How did your career trajectory evolve from there at Wellington?

Sarah: 06:39 I started in Boston. I was there for a couple of years, and then I ended up going to San Francisco. That was one of those sort of serendipitous things where my husband was offered a job in San Francisco, he's a private equity investor, and so I went to Wellington and said, "We really need a west coast office, don't we?" Because we did not have one at the time. And after a number of conversations, it was agreed that we did. So I went to San Francisco and I stayed there for seven years. That role was leading the growth of the business on the west coast, trying to understand a very different investment community. Connecting Wellington, which particularly at that time, it was global but it was very Boston-based, connecting that more to the west coast. Obviously there were very strong firms on the west coast, like Capital and others out there already.

Ted: 07:20 What did you learn about investing from your time at Wellington?

Sarah: 07:24 I think that the first thing I've learned is that investing has changed a lot over that time. So from the time I started, which was the early 90s, until now, obviously the investment world has changed. Back then, we could know information that other people didn't know. We could talk to companies and they would really tell us what they were thinking. That was before rule FD. There were plenty parts of the market, just to pick on energy, one of Ernst's thing was, "If you show up in Houston in August and Calgary in January, it's amazing what you learn." And that's true. So you could really know some things that others didn't know. I think that's really not true any more. It's just much, much harder to have an information edge. You can have an analytical edge, but not an information edge. And I think that the way that investing has evolved, obviously, is much more quantitatively driven, much more data driven. At least in those early days, it was really fundamental research in the classic sense of the word.
Ted: 08:23 Yeah. In Wellington, I think maybe people don’t know this, but has always managed a lot of Vanguard’s active money. So when you take that lens and say, "Oh, fundamental research used to have an edge. Today it’s more data." There’s obviously a lot of money flowing into the passive side of Vanguard. Where do you come out on active versus passive?

Sarah: 08:43 So I like to think it’s not active versus passive, as much as there’s really a spectrum of investing. One of the things that’s interesting about investing is, you know, we’ve all been doing this for a long time, we’ve learned a lot about it, and no one’s agreed on the right way to do it. Like if you talk to surgeons, there’s a right way to do heart surgery. Now, there may be a little bit of variation around, and some people may do it better, but people aren’t doing it totally the other way. It’s been proven which one is better. That’s not the case in investing.

Sarah: 09:06 So the way that I think about it is, there’s pure passive, there’s sort of enhanced index, there’s quantitative, there’s active but very tight to the benchmark, there’s active concentrated, there’s activist, there’s private equity. So it’s a spectrum. And I think, the way that I think about the investment business, at least, is that it used to all be about alpha. You could harvest alpha. There was alpha sitting out there that you could go pick up because a lot of players in the market were not as sophisticated. They weren’t as expert, which of course no longer the case.

Sarah: 09:41 So as I think about it going forward, it’s really asking investment managers what are they gonna get paid for. And there are a lot of things you can get paid for in investing. One is risk transfer. Maybe I have a different risk profile than you do. I can write an option that you want to buy. So that’s for the risk transfer. There’s solving the client’s problem. Usually the client’s problem or an asset owner’s problem is not, "Beat a benchmark by 100 basis points." Usually, it's, "Pay a liability in the future," or "Provide spending but also retain the principle." It’s something that’s more complicated, so how do you figure that out?

Sarah: 10:14 Clearly, there is alpha to be gained if you can, but then there’s also the beta or the underlying value of the companies. I think that increasingly, particularly big investors recognize that the money that they’re gonna make is not necessarily by harvesting alpha and beating the other guy. It’s by having economic value
of those companies actually grow and generate revenues and innovation and jobs and long-term shareholder value, which is then how they’re actually going to pay their liabilities in the future.

Ted: 10:46 That seems like a nice segue to talk about what you've been doing since you left Wellington. So before we get there, what was the rationale, after 21 years, that's a lifetime by some stretch, but you're still quite young. So what was the decision process to leave?

Sarah: 11:01 So I loved Wellington, I had no plans to leave Wellington. I think it's a wonderful place. I was very lucky to be there and be a partner there for a long time. But I met Mark Wiseman, who at the time ran the Canada Pension Plan, and Larry Fink, who runs BlackRock, and Dominic Barton who ran until just recently, McKinsey. They had this idea, this was their idea about, what is wrong with capital markets? What's wrong with capital markets is that, if we take a step back and say, "Why do we have capital markets in the first place?"

Sarah: 11:28 The reason we have capital markets is that we have savers, who have a long-term need to generate money. They don't need the money right now, but they need to put it somewhere. Usually, they’re saving for a long-term goal, such as their retirement, or the next generation, or future students of the school, or whatever it is. So they have a need to generate return over long periods of time.

Sarah: 11:49 At the other end of the spectrum, you have management teams who have an idea. They want to enter a new market, or build a new product, or create something. And usually those are also long-term ideas. Those take a while to come to fruition. So long-term needs to deploy capital, long-term needs to use capital. Makes perfect sense, you put them together. The challenge is, that the way that those get put together is through our capital markets. So typically what happens is, that money goes from a saver to a big asset owner, like a pension plan or an endowment or cyber-wealth fund, to an asset manager, through the public and trading capital markets into a publicly listed company.

Sarah: 12:25 In that process, that long-term goal on both ends really gets lost. And it gets very, very short term. I had seen this as a participant in the markets for many years. We all feel this if
we’re investing. I’ve also spent a lot of time in investment committees. You’re always trading off the long-term/short-term. And I think that our system has really, the balance is important between the two, and the balance has shifted towards the short-term. So I was intrigued with this idea. They had had this idea, they had set up, essentially, a consortium. They’d been doing a lot of work on this topic, but sort of off the side of the desk, and they had decided to go out and look for a full-time CEO to actually establish an organization to work on this.

Sarah: 13:05 I really liked them as people, I was intrigued by the idea. It was an idea that resonated with me, having been in the markets, and I think it’s an idea that we can actually solve in some ways. We created these things, so we can fix them. It’s not world peace. We’re not doing something that’s impossible. We’re trying to fix capital markets. That’s a pretty big ask, but it’s something we’ve created. So I was intrigued enough to decide to walk out of Wellington after all those years and go lead this.

Ted: 13:30 So when did you start?

Sarah: 13:30 Two years ago, July 1st of 2016.

Ted: 13:33 The concept is great. What do you do?

Sarah: 13:36 Yes. So, we’re really thinking about it in three ways. The first is, can you quantify the problem? Is this just an annoyance, or is this actually a real problem? Is it a quantifiable problem? And so the first question is, "How big is this?" So with McKinsey, we’ve done a lot of work. We can go into it in more detail, but sort of the punch line is, if you look at how long-term companies have behaved, long-term companies on a number of financial metrics, versus how short-term companies have behaved, what you see is that long-term companies outperform in terms of revenue, profitability, share appreciation, job creation, all the things that you would look at, over any reasonable period of time.

Sarah: 14:15 But in the crisis, you could see that they got punished much more harshly than short-term companies. So managers are not wrong when they say, "I want to be long-term, but I feel this pressure." So what we see is, long-term companies outperform short-term companies over any long-term period of time. But
it's challenging. And to put some metrics on it, in the United States, over the decade leading up to 2016, if the short-term companies in this country, and I know this is a big "if," if the short-term companies in this country had been able to behave like the long-term countries, they would have created a trillion dollars of additional asset wealth and five million more jobs. So think of all the things that would be different if we had done that. It's a big issue, and so even if we can move this dial a little bit, it has the potential to have a big impact.

Ted: 15:03 So let's unpack that a little bit. What's a long-term company and what's a short-term company?

Sarah: 15:08 Typically what you see is that long-term companies continue to invest through cycles. So if you look at R&D as an example, and if you look at short-term company versus long-term company, a longer term company will continue to invest through that, whereas a short-term company, knowing that they're going to miss their earnings because markets are bad, they will pull back on that. So then, of course, they have to restart. And so you see the difference in how that pays off, and usually the long-term companies are the ones that are doing things like building earnings, not just EPS.

Sarah: 15:39 So if you look at EPS relative to change in earnings, which usually means you're changing your shares around, if you look at R&D or other sorts of [cap-x 00:15:48], if you look at accruals versus revenues. If you look at companies that are willing to miss their guidance ... So you can find these sort of tells of what a long-term company is, but typically long-term companies are more counter-cyclical and short-term companies are more procyclical. Markets get bad, they lay everybody off, they re-trench, whereas a long-term company will then go and try to pick up customers and employees and so on.

Ted: 16:12 And is there some correlation with, the two things that are popping in my head as factors are size and industry.

Sarah: 16:19 Mm-hmm (affirmative). So, the work that we did was split by industry. So, in other words, we compared within an industry, the short- and long-term companies. And you see clearly the amount of time that is long-term in tech is different than in mining. But if you look within an industry, you still see that variation. And in terms of size, the size isn't really the factor.
What tends to be one of the drivers is how strong a company is, which may or may not have to do with size. But if a company is a going concern and expects to be a going concern for long periods of time, then obviously they can behave more long-term. If a company gets to the point where they're more distressed and they feel like they've gotta sort of live to fight another day, then naturally they will-

Ted: 17:00
Is that tied to the right hand side of the balance sheet?

Sarah: 17:02
A lot of it is, yeah. A lot of it is.

Ted: 17:04
So that's the first we've now quantified that we can do better.

Sarah: 17:07
We can do better, right. So how do we do better? Our theory of change, at least, is that, for companies it's very clear that long-term companies do better. For investors, the same is true. There's very good evidence that long-term investors do better than short-term investors. What's interesting about this long-term issue is it's in people's own self-interest. We're not asking somebody to do something that's not in their interest. So most investors and companies say, "Well, I want to be long-term, but I'm getting pressure from the other guys."

Sarah: 17:32
And the asset owners say, "We're really long-term, we've got 25 year liabilities, but these asset managers and companies act short-term." The asset managers say, "We're really long-term, but if we underperform for a couple quarters we'll get fired." The companies say, "We're long-term, but the investment community's putting this pressure on us."

Sarah: 17:47
So the idea is to get those three groups together to say, "Okay, why is this happening? And where are those pinch points?" So I'll give you one example. We've done a lot of work on quarterly guidance. Quarterly guidance has actually gotten a lot of press in the last month or so, but we have done sort of the fundamental work on the issues about quarterly guidance. There are a few interesting facts about quarterly guidance. The first is, it's not a phenomenon in most countries. It's a U.S. phenomenon. But even in this country, it's down to about 27 and a half percent of companies actually issue quarterly guidance, so it's a minority practice. It's very clear that some of the myths around quarterly guidance aren't true. A lot of people believe it lowers volatility of the stock. That's not true. Or it
increases valuation, the credibility premium, yet that doesn't exist. And so some of the myths about why to do quarterly guidance don't exist. But the problems a quarterly guidance causes are very clear.

Sarah: 18:39 So quarterly guidance has a feedback loop to the management team, and they will often cut R&D, cut human capital, things that can be cut in order to hit it. And giving quarterly guidance also attracts short-term shareholders. If you give people short-term numbers to play, they will play them. So quarterly guidance is one of these things where, by doing deep research and actually unpacking some of these myths, looking at the data in conjunction with some people from Harvard Business School and others, we've been able to show that. And then that, I think, has entered the public consciousness of quarterly guidance is a bad practice and we shouldn't be giving quarterly guidance. Not quarterly reporting, which is historic reporting of facts, and not even annual guidance, which is longer term. But this short-term quarterly guidance is a real negative.

Ted: 19:26 And we're probably in the first or second inning of some influential business executives saying the same thing. How do you get the message out?

Sarah: 19:35 So we've done it in a couple of ways. One is, it's very helpful to us. We have a great board and group of supporters, I should start with that. Our board is made up of leaders of some of the most well-respected companies, like Unilever or Dow, asset owners, like CPPIB or GIC or asset managers people, BlackRock and many others. So one is by having a group of well-respected people sort of support this, get the message out.

Sarah: 20:03 Another is by having that influence more broadly. So the Business Roundtable published some things about quarterly guidance earlier this year, just a few months ago. That was very helpful. We obviously have a lot of overlap with the Business Roundtable. So having organizations like that. And then on that one in particular, the National Investor Relations Institute, which is sort of the group that covers investor relations people, has also changed their policy on quarterly guidance. Of course, they made their own decisions, but our work went into that. That is how we get that message out. We're all about change. We're trying to move the dial on capital, we're not a think tank. Mark Wiseman likes to say we're a do tank, not a think tank. So
we’re not interested in having research that sits on a shelf, we're interested in moving capital. So how do we do that? Part of that is by having big backers.

Ted: 20:49 So I’m envisioning, "Oh, we've dropped quarterly guidance. We’re just gonna give annual guidance every quarter."

Sarah: 20:54 Yes, that's cheating. But the annual guidance that's updated every quarter is quarterly guidance. There is some of that. But it's not about giving less information, it's really about changing to the information that is important. So what do investors care about? What they care about is, where is a company going over the long run? What is its strategy? Or to use Larry's words, what is its purpose first? Then, what's it's strategy? And then, really, what are the indicators of whether it's making progress or not?

Sarah: 21:22 In every business, there's some indicator. Is it patents that have been received, is it number of customers through the door? Whatever it is, there are real indicators that the management team, of course, watches, that are leading indicators. And then, how does that translate into the actual financials? The EPS on a quarterly basis is very much a trailing number. It is a outcome. What really matters for investors is what's gonna happen next. And so it's instead focusing on, "What's our strategic road map? Where are we going? How do we measure if we're on track?"

Ted: 21:52 Yeah. And then, the quarterly guidance, clearly over time, has worked its way into perceptions that needing guidance improves the stock price, and stock price is tied to compensation plans. How have you thought about compensation and corporate executives?

Sarah: 22:08 So, we haven't done deep work on compensation yet. But I will tell you a couple of interesting things. The first is, we've done some work with some, George Serafeim at Harvard Business School, who you may know. He's done a lot of work in this area. He's terrific. And one of the things that's very clear is that executives that have longer dated compensation act in a longer term way. Now, this should not be a surprise to anybody. We think a lot of the problems around short-term-ism have to do with incentives. If you pay people to be short-term, they will. And sort of habits, we've got all these strange habits that have built up in the capital markets. And then also some of these
behavioral finance mistakes that we all know about. But if you pay someone to be short-term, they will be.

Sarah: 22:46 So their numbers show that that's very clear, the longer compensation leads to longer term behavior. But that the average duration of CEO compensation, realized duration in this country, is about a year and a half. So if you're paying somebody on about a year and a half, you kind of expect them to act in that time frame. That shouldn't be a real surprise to anybody. And part of that comes back to the board, which is another thing we're working on.

Ted: 23:10 Presumably that flows its way into how they make capital allocation decisions as well.

Sarah: 23:14 It does.

Ted: 23:15 Is there research on the capital allocation process? You mentioned it in terms of dividing up long-term and short-term companies.

Sarah: 23:22 So we're still working on that. But there's two problems with the capital allocation process. One is how capital is actually allocated within a firm, and that's very important. And then the other part is how that capital allocation process is explained to their investors. Investors are typically somewhat cynical, and know that the management teams come and say, "Oh, we've got all these wonderful plans."

Sarah: 23:44 But many management teams haven't done a great job of saying, "Well, over history, we've invested like this, and here's how it's paid off." So having built a track record of being good capital allocators, and because CEO turnover is fairly high, it's easy to say, "Well, the last guy screwed that up, but I've got a great plan."

Sarah: 24:02 I think both of those sides are important. But I'll give you a quick story. I won't attribute it. I was speaking with somebody from one of our members who was talking about their own capital allocation process. And he said they look at everything over three years. So I said, "Well, what if you've got, pretend you've got a hypothetical project and it looks like five year zero coupon bond. You're gonna get zero, zero, zero, zero. And then in year five, you're gonna get a return that's twice your hurdle rate. Will you do that?"
Sarah: 24:30 "I'm not sure we could do that." That is the problem. That makes no sense. If that were your money, you would do that in a minute. So there are issues there, and we're beginning to unpack those.

Ted: 24:42 So at the company level, we have guidance, which we know is pernicious, and how that filters into compensation plans and capital allocation. Are there other key areas that you're looking at at the company level?

Sarah: 24:56 The other key thing we're working on at the company level, and then we can switch to the investor side, but at the company side is the board. What happens time and again is that the board is cited, either as a source of short-term pressure or as a ballast, sort of as the long-term ballast. And so the question is why? Why does one corporate board behave in a short-term way and another corporate board behave in a long-term way? Even sometimes when they have some of the same individuals on them. So that is part of the work that we're doing now. We've put out one paper on that, which we're calling an idea exchange. It's really meant to be a conversation starter and it came out of a summit that we had about some of the practices of longer term boards. That's actually one of the projects that we're in the midst of, but it's very clear that the board is a key contributor to either that short-term mindset or the long-term mindset.

Sarah: 25:51 I'll give you one very simple example, Amazon's board, Amazon is often quoted as a very long-term company, actually explicitly has in their corporate governance documents that their responsibility is to what they call the "long-term share owner," and so they don't get themselves into this "Who's our duty to?" Their duty is to the long-term share owner, and that's very clear and if you don't want to buy that stock, then don't do it. That's who their duty goes to.

Ted: 26:18 Do you have any working hypotheses of those situations where [inaudible 00:26:23] similar board members and one behaves more long-term than the other?

Sarah: 26:25 Yeah, I think that a lot of it has to do with, it's blocking and tackling. Some of it has to do with how do they set up the meetings. Does the board, for example, spend a lot of time worrying about the quarterly numbers, or is that delegated to a
sub-committee? Do they spend enough time on the strategic issues? Do they have the right people on the board that are sort of future focused, that are the kind of people that think long-term?

Sarah: 26:51 So there are a number of these things, and what we haven't figured out yet is which is the most important. But there're a lot of things that I think companies can sort of look themselves in the mirror and say, "Hmm, are we doing that?"

Ted: 27:03 Must have thought along the way about the group of activist investors and the impact that they have on boards and short- or long-term behavior. Any thoughts?

Sarah: 27:14 Yes. So, clearly, the activist investors have had a lot of impact on boards and management teams. They've had impact where they've been involved, and they've had impact where they haven't even been involved because people know they might be involved. So the way that I think about that is, if there is a company that is poorly managed, let's say they've got lots of corporate jets and they don't have their eye on the ball, then an activist can come in and they can raise the returns for everyone. They can raise the returns for both the short-term investors and the long-term investors. And that is what some of the activists have done. The challenge is, most companies know that and they're trying to do that to themselves these days.

Sarah: 27:56 So then the question is, what is the time frame of an activist versus the time frame of a long-term shareholder? Particularly for, obviously for our passive holder, but even for a large, any sort of large fund or large asset owner. They will own most companies that are listed, essentially forever. They will own them in different proportions, but they will own them for very long periods of time. So they don't really care very much when value is realized. They just want value to be realized over some period of time.

Sarah: 28:29 Activists, on the other hand, as a general rule, have a much higher discount rate. They have sort of promised their investors a much higher rate of return, and sort of just the way the math works is that therefore, things that come to fruition, three or five or ten years out are not worth very much, because you're discounting them back at a very high rate. So an activist, or a short-term investor of any sort, would much rather have less
money sooner than more money later. And so the challenge with the activist, or any short-term shareholder, is that their interests are not the same as that of a long-term shareholder. So if you're sitting on their board, a board of a company, and you have to make a choice between something that looks more like a J-curve, is gonna pay off over time, or not, and then you feel that short-term pressure, you're unlikely to make that investment. Even if that's the right thing for the company for the long-term shareholder and for the future of the community and the savers. So that is where the problem is, that there is mathematically impossible to optimize for both a high discount rate shorter term investor, and a lower discount rate longer term investor. So boards have to choose.

Ted: 29:48 Yeah. And the way that human behavior works, the true long-term ultimate holder tends to be the index funds.

Sarah: 29:54 Yes. Or broadly diversified funds.

Ted: 29:57 Sure. But you know that BlackRock's SMP 500 index fund is gonna own Amazon 25 years from now with near certainty. They also tend to be quiet. So, on the one hand, you have Bill Ackman's on the phone to the board, which rattles people's nerves. And oh, Larry Fink won't be there, but someone else will be running BlackRock 25 years from now, and no matter what you do, they're gonna be a shareholder. So human nature almost dictates that the board's likely to respond to the more vocal, shorter term voice.

Sarah: 30:26 Yes. That's exactly right. And I think one of the things that is important for boards to understand, usually not when they're in the middle of an activist situation, but on an ongoing basis is, who are their biggest shareholders? And what do they care about? And who are the long-term shareholders? Because once you're in the midst of one of those situations, it's a little late. So one of the other things we've been working on is engagement between long-term shareholders and corporations is critical.

Sarah: 30:52 So how do you do that on about long-term value creation? So about strategy, about building that value for the future. There are a lot of ways that people do that. So some of those quiet shareholders will have meetings where they'll just give feedback to the management team. They'll have a management team come in and they'll say, "We're not gonna ask you any
questions. Here's what we think you're doing." Smart management teams, of course, will ask their investors for feedback, because typically those investors will see all their competitors and so on.

Sarah: 31:21 How do you create that in a more robust way? Is part of the challenge. So we've got one of these idea exchanges that we've just published a few weeks ago as well about tools and mechanisms for corporates that want to hear from their quiet long-term shareholders, and sort of quiet long-term shareholders that should be speaking up and have often, I think historically, sort of let the activists do it for them. Which again, works fine, if the company is poorly managed, but doesn't work well if it's a short-term/long-term situation.

Ted: 31:51 What are those tools?

Sarah: 31:52 One is literally giving companies feedback. Others are sort of sharing their analysis. Most equity investors, most buy-side investors never share their analysis of a company with the company. But if you do sort of an outside-in analysis, and you show a company, "Well, here's what we're looking for, and this is what we're gonna look at," most management teams are fascinated by that and they'd love to see it.

Sarah: 32:13 Now, they often see the sale side analysis, but again, that tends to, on average be shorter term. So it's really about building that dialogue, that two-way street.

Ted: 32:23 So let's turn a little bit to the investor/allocator side, where there's a whole set of similar issues.

Sarah: 32:29 There is.

Ted: 32:30 Where have you started focusing?

Sarah: 32:31 So the place we've started is on the mandates. So when an asset owner hires an asset manager, the way they set up that mandate can either lead to a very long-term relationship or a very short-term relationship. And obviously that behavior then translates through to the real economy. Thoughtful long-term asset owners have done this for some time. There are a number of asset owners who think about building relationships over very long periods of time, who want their managers to succeed. They sort of put things in place that work. Unfortunately, what a
lot of asset owners do is they look at the numbers, they hire the manager who has just performed well, and then because of aversion to the mean, or bad luck, or whatever, taking in too many assets, that performance rolls over. And then they fire them, and then they do it again.

Sarah: 33:21 So you get this sort of sawtooth pattern, which is, there are a lot of good ways to invest, but "buy high, sell low" is not one of them. So how do you get out of that pattern? I'll give you just a couple of examples from how they set these things up.

Sarah: 33:35 So there's some interesting ideas, and the way we do our work, I should say, is that we have big asset owners and big asset managers. We've gotten them together, it's been a little bit of a sharing process. Someone will say, "We tried this and it worked," and somebody else says, "Oh, really, well, we tried this." And it's sort of in a very safe environment.

Sarah: 33:52 But a few of the ideas, one is this idea of a longevity discount, is that rather than, as you probably know, typically people get discounts for putting more assets to work, but there's also this idea of giving a discount over time. So it starts at whatever it is, let's say 60, 55, 50, whatever it is over time. And the reason that makes sense is, for the asset owner, obviously the fee goes down over time, so that's a good deal. And for the asset manager, it's a lot less costly to have an asset owner continue with them than it is to be fired and go out and get a new client. So it's in their interest as well.

Sarah: 34:28 So that's one, it's a win-win. It's in both of their interest. And the idea is very simply to put a speed bump in that firing process. So obviously, if the manager's off the rails or they've done something they shouldn't be doing, you fire them. But if it's just this pattern of performance, perhaps people take a step back and hesitate.

Ted: 34:47 Yeah. What about, you started by saying the mandate.

Sarah: 34:49 Mm-hmm (affirmative).

Ted: 34:49 What makes for a sensible mandate that allows an asset manager and owner to communicate effectively?

Sarah: 34:57 I think a lot of that is about expectation setting up front. There's no right or wrong mandate. In other words, one person could
say, "This manager's job is very narrowly to beat a particular benchmark," and another could say, "Well, no, it's an absolute return. They can go anywhere."

Sarah: 35:12

So there isn't one right or wrong way of managing money, but what's important is that the asset owner and the asset manager are on the same page about that, and that there's a little bit of "trust but verify." So there is a sense of, "Why are we hiring this manager in the first place? Is it because they have a terrific team? Is it because they have offices around the world? Is it because of their investment philosophy?" Whatever it is, and understanding what those things are, and then really tracking those. It's sort of like the KPOs on a corporate. It's really tracking those over time.

Sarah: 35:49

If it's because they have a great team, and then all of a sudden, the turn over on their team goes up, then maybe you should be worried even if the numbers still look good.

Sarah: 35:56

So one of the things we did at Wellington years ago, I was responsible for overseeing a number of portfolios that the OCC also was responsible for looking at. And they always, of course, wanted us to put things on the watch list if they had underperformed. And we convinced them, I think we finally convinced them, that they should also put them sort of on the watch list if they had overperformed. But that's against human nature. So if something is out of expectations, whether it's too good or too bad, why? What's happening? And it's a lot easier to track that if you're very clear up front. What are you trying to accomplish, and why do we think this is a good investment?

Sarah: 36:31

That revisionist history is rampant in the investment business.

Ted: 36:35

What's your take on use of benchmarks?

Sarah: 36:37

I'll tell you that when we went into this work on this whole mandate, I thought that there was gonna be a silver bullet about benchmarks. We all hate them, right? Everybody in the investment community hates them. That there must be some better way. And I'm not sure that there is. Because the thing with a benchmark is, it's a communication tool. And there are times when managers don't perform or go way off of where they're supposed to be, way out of their mandate. So there has to be a communication device, and the benchmark is that.
Sarah: 37:06 Now, that doesn't always mean you have to have tight tracking error to that benchmark, it doesn't always mean you pay somebody against that benchmark. But I think having a clear set of communication tools in the investment business usually includes a benchmark.

Ted: 37:22 And are there other mechanisms on fees that you've thought of in addition to this sort of loyalty discount?

Sarah: 37:28 Well, clearly, performance-based fees that are back ended. There's a lot of behavioral work that says that something that is escrowed is longer term than something that's a claw back. We have this loss aversion. So sometimes people have these fees and there's a claw back. If you then underperform, it doesn't really work with our brains very well. So something where you actually don't receive the fee until longer periods of time is clearly very helpful.

Sarah: 37:54 What I have found in the investment business is that most investors are really trying to do the right thing. They're trying to perform. So most people are not gaming a fee, but you have to think about what the incentive is, because that is human nature. You also have to think about the way things are presented. So sometimes investors complain that their LPs are very short-term or their clients are very short-term, but then you read their investment letter and it starts with, "Dear Investor, This quarter we returned 7.2% versus ..."

Sarah: 38:25 Well, of course they're short-term, you just told them to be. So one of the other things, it sounds very simple, but that a number of our members and others are doing now, is that typically the way investment reports work is they show you return versus a benchmark, quarter, year to date, last 12 months, one year, three, or five. And we're actually flipping it. So you start with the number that actually matters. Maybe it's the seven year number. And it really reframes the mind, and it really gets people starting to focus on those long-term time frames.

Sarah: 38:56 So a lot of this is not changing the world in a top down way, it's poking and tweaking and recognizing our own biases and recognizing our incentives and pushing on everyone and saying, "Are we doing something here that is supportive of long-term behavior or not?"
Ted: 39:13 One of the big differences you see in public and private equity investing in funds is that private equity experience generally has been better than public equity. There are a lot of reasons for that, one of which is, "Hey, we just put our money in a lock box for ten years." Are there different ways of thinking about liquidity of public equity manager/allocator relationships?

Sarah: 39:34 So, first of all, I think that's right, and I think one of the ... There was a CIO of a big sovereign fund I know well who, during the crisis, was forced by his oversight committee to sell his public equities because people got scared, but couldn't sell his private equities and told me later, he said, "I don't need an illiquidity premium. I would pay to be locked up, because then I know my committee can't make me do that again." And so I think you've got this very strange situation where, what we were all taught in school is there's an illiquidity premium, but maybe, maybe not. So humans make bad decisions about time, and we particularly make bad decisions when we're scared. One of the other things that we've been working on is what we're calling a risk conversation guide, which is, because what normally happens is you have some sort of investment committee board oversight group. And they speak one language, and then the investment and risk professionals come in and they speak ... We love VAR and VOL and all these things.

Sarah: 40:31 And you have this conversation, but both sides don't really quite understand the other. Then something happens, a bump in the markets. And there wasn't a strong understanding there, so then people get very short term, and then they want to sell, and then they put that pressure on selling, usually, the thing that's liquid. Which is usually public equities.

Sarah: 40:50 So part of the question is, "How can you cut that off up front? How can you have a better understanding?" And what I see with some of the best investors is that they have mechanisms, whether it's rebalancing, or whether it's the way their committees are structured, or whether it's the fact that somebody has been there for a very long time, or that the committee's been there a long time so they've already got these scars, that allows them to ride through those times. So a lock-up can be one way of doing it, but you can also create that with structures as well.
Ted: 41:22 How does transparency between managers and allocators play into the ability of both to be long-term?

Sarah: 41:31 I think in general transparency is a good thing, because it leads to a better understanding. There are a few cases when it's not a good thing. One of the challenges for many investment managers these days is that a lot of their clients are both investing through managers and investing on their own account. And so investment managers, rationally, sometimes can be scared of showing their positions to ... You know, you have a hundred million with somebody, but you know there's a hundred billion behind it, right? That can be scary. So I think that comes back to the trust. So if there is a long-standing relationship where you have been through a couple of bumps with somebody else, then that transparency opens up. If it's transparency either to front run you, follow you, gotcha, that's not gonna help anybody.

Ted: 42:17 If you imaging a world 10 or 20 years from now where you've been successful and there's a meaningful shift in the amount of capital of the hands of, let's just call it more long-term investments, relative to the asset management universe today, who are the winners and who are the losers in market share?

Sarah: 42:40 I would start with that I think the winners are the savers at the end of the day. Because remember, let's take a step back. The goal of this is to benefit savers who will be old at some point and need to be supported. We all know we've got a massive time bomb in terms of our pension system. So, to be successful, what we hope would happen is that those savers live better in their retirement. Or that next generation has a better standard of living.

Sarah: 43:11 And at the other end of that investment value chain, they are communities, they are real people, they are people who have a job, who wouldn't have a job, or have a product or a medicine or whatever it is that wouldn't have otherwise been developed. So we're a non-profit, we're a 501(c)3. So that is the ultimate goal, is to improve life for the savers and the communities.

Sarah: 43:32 In terms of market share, one of the things that I find fascinating about the investment business is that there are always smart people trying to figure out the angles. So if we get more indexed, then theoretically, at least, those active players
who are left will make more money, and there should be some balance at some point there.

Sarah: **43:49** So it's hard for me to predict who a winner from a market share would be, but I think that the goal is that the savers and the communities are the winners.

Ted: **43:56** How different is this in the U.S. from the rest of the world?

Sarah: **44:01** I think that humans are fundamentally pretty similar around the world. There are some things that are different here, quarterly guidance, for example. But this idea of the long-term/short-term trade-off is inherent everywhere. There are some cultures that are more long-term in their corporate structures because they tend to be more family-oriented. Family companies, as a general rule, may have other issues but they tend to be very long-term. And partly that's because they can sort of envision the grandbaby that they're doing it for, it's real. So some cultures are longer term in that way. Some cultures don't tolerate failure very well, so if somebody takes a risk, and we all know in the investment world, a lot of risks don't pay off, there are places where that's not tolerated. So they tend to be very short-term in terms of investing.

Sarah: **44:48** We certainly haven't cornered the market on being short-term, but there's no culture that I've seen yet that doesn't have some of these short-term behavioral issues.

Ted: **44:56** What are your next set of either tools or initiatives to promote this going forward?

Sarah: **45:03** I think that the big ones that we're working on right now, one is this more deep work on investment risk. And there are, obviously there are a lot of people who've thought a lot about investment risk. But it's this, sort of the interaction of investment risk and real people, particularly when it's not their money and particularly over time. Those time trade-offs, those communication trade-offs, I think that's really fundamental. The goal, as one of our board members likes to say, the goal is excellent long-term performance with reasonable short-term performance. So what's the definition of reasonable and how do you make ... Because if you get taken out in the mean time, it doesn't matter, right?
Ted: 45:40 It doesn't matter. And is that that risk piece that you focused on?

Sarah: 45:42 And that's that risk piece. So that's, I think, a very-

Ted: 45:46 So what do you do with that concept?

Sarah: 45:46 What we do with all of our research is we develop it with our members. We have 40 members now around the world. Asset owners, asset managers, and corporations. We sort of do the academic research, we do all the homework. We bring people together and really test it to be sure it's practical. And then, we treat our members a little bit as a test kitchen. They take something off and they try it. They'll come back and say, "Oh, that worked, but that one didn't." And then we refine it. And then we make it all public.

Sarah: 46:11 So we are, as I said, we're a non-profit, so all of that is available on our website when it gets to be at that point. So the idea is that, by definition, our members are not typical. They tend to be big, global, sophisticated organizations. But the goal is to create things that benefit people more broadly.

Sarah: 46:30 So risk is one, board's an important one, we talked about that some. This whole engagement between investors and corporations is a critical one, and thinking about how do we really make that happen. So those are sort of the top three we're working on. And then the other thing that we're working on, which is a bit of a challenge, is a scorecard. So the first question it was sort of, "Is this a big problem?" Yes, it is. We could do more work on that, particularly in some other countries. Second is, "What are the practical tools?" And then the third is, "How do we know if we're making any progress or not? Are we getting longer term or shorter term?" So we're working on what are the indicators of long-term in the ... For asset owners, asset managers, and for corporations. How do we test them? How do we get that data?

Sarah: 47:11 So we'd love yours or anybody else's ideas. We're in the midst of that process right now.

Ted: 47:17 That probably dovetails into, I was thinking of asking, which is, as technology has sort of just started to work its way into the asset markets, how do you think about the importance of technology on this agenda over time?
Sarah: 47:30 Yeah. I think it's critical. Because I think that many of us were brought up with the idea that the way you manage money is you start with a blank piece of paper and you sit down and talk to somebody who runs a company and you decide whether they seem to have a good strategy and know what they're doing or not. That's not the way most money is managed, and it's certainly not the way money's gonna be managed in the future. We've been thinking about, how do you have an engagement when it's actually quantitative structure or a quantitative investment strategy? Do computers have engagement? I don't know. So I don't have the answer for that, but I think it's absolutely critical, because there's no question that that is where this world is going.

Ted: 48:06 Yeah. All right, Sarah, I want to turn to some closing questions. But before that, where can people listening find you and the work you're doing?

Sarah: 48:14 Our website, www.FCLT, for Focusing Capital on the Long Term, FCLTglobal.org. And everything we have is there. We'd welcome some input and feedback.

Ted: 48:27 All right. Here we go, some closing questions. What was your favorite extracurricular or sports moment?

Sarah: 48:34 So probably my favorite sports ... I don't always admit this, but I played rugby in college. I played for Williams College, and we had not the biggest team. We were a small team, and one year, we played Harvard. Probably the funniest sports moment in my life was, one of my teammates tackled a girl and she reached up and grabbed her shirt to tackle her and she ripped her shirt, and the girl did not have a bra on. The entire game stopped and everybody fell down laughing on the field.

Ted: 49:03 Well that was probably where Justin Timberlake and Janet Jackson got their idea from.

Sarah: 49:08 Maybe that's where they got it from.

Ted: 49:08 I think one of them was watching the game.

Sarah: 49:10 That's right.

Ted: 49:11 What’s your biggest investment pet peeve?
Sarah: 49:15 My biggest investment pet peeve is people who take advantage of investors who are not sophisticated. So I think that they forget that the reason for the money is not to fund our industry, or to trade, or to whatever, but that the reason for the money is to provide dignity to people in their old age, or for their children. And that gets lost, so that's my biggest pet peeve.

Ted: 49:42 What's the riskiest thing you've ever done?

Sarah: 49:44 The riskiest thing ... Well, I did go zip lining once, which I thought probably wasn't that risky, but at the time it was ... I have three kids and they all, each one of them went off of this huge mountain. And I swore I wasn't gonna go, and then I was like, "Well, I kind of have to go, because my kid just went." So I did it. I'm not sure that was that risky, but it felt like it at the time.

Ted: 50:04 What teaching from your parents, I'm sure there was a lot as teachers, what teaching from your parents most stayed with you?

Sarah: 50:10 As I said, my family are all academics, and they've had the habit, I think, of pointing out when they think something isn't right, and standing up and mentioning that. I've learned from that. And that there is always a debate, there's always a way to, if you see something that doesn't seem right, to stand up and either learn why it is or isn't or try to fix it.

Ted: 50:31 Yeah, that's great. What information do you read that you get a lot of out of that other people might not know about?

Sarah: 50:37 Well, I'll tell you about one thing that was introduced to me by ... So, I have two daughters who are in their 20s. Do you know what The Skim is? Are you familiar with The Skim?

Ted: 50:45 No.

Sarah: 50:46 Okay, so The Skim is a daily newsfeed that is written for 20-something females. First of all, it's really well done. It's funny, and it's very appropriate for that. So I read all sorts of more typical investment things, but that is one where, that's how I actually know what's going on with the young women in my life.

Ted: 51:05 Wow, that's great. All right, last one. What life lesson have you learned that you wish you knew a lot earlier in your life?
Sarah: 51:12 I'll tell you a quick story. My son, when he was about four years old, had this habit, which I'm sure many children do, of would never walk on the sidewalk but had to climb on the wall. And would walk down the wall next to the sidewalk. So, like a typical parent, I once said to him, "Be careful, you might fall off." And he looked up at me and he said, "Yeah, but I might not." And I've always remembered that lesson. I might not fall off.

Ted: 51:37 That's great. Sarah, thank you so much for taking the time. And good luck, because this is such an important mission for all of us.

Sarah: 51:45 Well, thank you. I appreciate your time and your thoughts.

Ted: 51:49 Hey, before you take off, I've started sending out a monthly e-mail that shares a small selection of what caught my eye over the month. I get a lot of e-mails like this, and I'm sure you do too, so I'm only gonna send no more than a handful of the very best things that caught my eye. If you'd like to receive that e-mail, hop on my website at capitalallocatorspodcast.com and join the mailing list.