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How to attract long-term investors: An interview with M&G's Aled Smith

The award-winning fund manager discusses what he looks for in a company when he's making investment decisions.

Marc Goedhart and Tim Koller

Executives overburdened by the demands of their companies' short-term investors may yearn for a more supportive crowd that might be less skittish about volatility. Such investors would base their decisions on a deeper understanding of a company's strategy, performance, and potential to create long-term value—and would not pressure a company for short-term gains at the expense of greater long-term growth.[1]

Attracting such investors can prove something of a challenge. Certainly, executives are often highly coached when they talk about their strategy and objectives, and have extensive information about potential investors and their style and approach to investing. Too often, though, those messaging cues come from sell-side analysts, who may have a shorter-term agenda. So says Aled Smith, who manages the Global Leaders Fund and the American Fund at M&G Investments, based in London.[2]

Smith recently joined Marc Goedhart and Tim Koller in McKinsey's London office for this wide-ranging interview on what he looks for in potential investments for his portfolios.

McKinsey: *In a world where investors and analysts often focus on short-term returns, how do you differentiate your approach? What characteristics do you look for in the companies you consider for your portfolio?*

Aled Smith: My strategy is based on the observation that a lot of companies are making good long-term investments that may hurt short-term cash flow. Investors often overlook these companies because they shun earnings and cash-flow volatility. Today this aversion is extreme—they aren't prepared to admit that the world will still exist in five years, so they want to get their money back sooner, and volatility works against that. Eventually, the markets will see earnings and cash-flow volatility as a good thing again because it's being priced so attractively. In the meantime, that's what I look for—especially the volatility resulting from corporate restructuring and change.

Let me put that into context. When I started investing in the early 1990s, information was imperfect and not freely available. Having a valuation framework was a competitive advantage; having sensible inputs into it was even more so. Today, those things are available off the shelf, and it's rare for one investor to know something others don't.

Since the information-gathering component of outperformance is basically gone, the role of the analyst now is to understand an industry rather than just a company. If you can do that and take a longer-term, bigger-picture view of disruptions in the industry—the big shifts that might take five or six years to play out—then all that conventional analysis can still offer an advantage.

McKinsey: *What kinds of clues do you look for that might promise long-term growth?*

Aled Smith: The key is not to explicitly look for growth, as the chances are it will be priced in. So we have two strategies. One of them is to look for quality businesses you can trust to make good decisions—and the clue is in the company's performance on dividends. This is the Global Dividend Fund strategy. The best companies have an element of capital scarcity in their culture. Rather than just growing an asset for the sake of growth, these companies prune bits of the business and cultivate continuous improvement. And the first thing the board does every year is raise the dividend, which keeps the list of strategic moves short and focused and allows less money for silly things to happen.

The second strategy is to look for growth before it is recognized, that is, in companies where any potential growth surprise is not considered possible. This is the M&G Global Leaders strategy. The clues we look for are subtle ones in changing asset-allocation policy, measurement, and incentives. Most low-valued companies are valued low for a good reason. We identify those among them that are making positive internal changes—and then we can call these companies cheap.

We don't want sprinters; we want healthy long-distance runners and great runners that are recovering from injuries and have been written off.

McKinsey: *How does your dividend fund react to the trend, particularly in the United States, of companies using share purchases to distribute cash flow instead of dividends?*

Aled Smith: The evidence suggests that CFOs are not good at timing share purchases, so we prefer the board to focus on dividends, thereby signaling a healthy underlying culture with a lower risk of derailing and doing something wrong.

Companies that are among the dividend achievers likely have a certain kind of business model, and the good ones also tend to do buybacks in a dividend-like manner. The challenge, then, is more about whether a CFO can commit to a strategy—and that commitment becomes a statement to the market, like a dividend. What we'd like to see in buybacks is the share count meaningfully going down over time. Over the past decade, there were probably only seven or eight companies in the S&P 500 that reduced the share count every single year. Those companies, although statistically a very small sample, have performed quite well.

Ultimately, what we're talking about is an agency risk that the market responds to. So, if you can say to the market, "We've got a great business model, we're going to grow your dividend and income every year, and you can trust us," then you get rewarded for it. The challenge is how to make that statement to the market and gain the trust of your shareholders. For example, we know that great companies make acquisitions as part of their growth strategy. Building trust there requires showing shareholders both how a deal has created value and how it's been audited. The same goes for R&D and other capital investments.

McKinsey: *How do you decide whether management is trustworthy?*

Aled Smith: Ultimately, you have to just track what decisions are made. What matters to us is that companies can explain their strategy. At the risk of sounding corny, it's a bit like an episode of South Park called "Gnomes."[3] The story was that these gnomes came up with

Aled Smith

Education
Graduated from Lincoln College, Oxford, with a BA in mathematics and is a CFA charterholder

Career highlights

M&G
(2000–present)
Joined in December 2000 as a global equity-fund manager

JPMorgan Asset Management
(1992–2000)
Senior analyst for the media sector

Coopers & Lybrand, 1989–1992
(1989–92)
Actuarial consultant

Fast facts
Winner of 3 Sauren Golden Awards in 2011, including 2 for US equities and 1 for global equities

a business idea of stealing underpants. And when someone came along and asked them to explain it, they responded with what they called a three-point strategy: point one is to steal underpants and point three is to make lots of money—but point two is missing. And unfortunately, probably 80 percent of corporate presentations fall into the same trap, confusing strategy with objectives or aims with ambitions. Their explanations are like those of the South Park gnomes: "We're going to build this great platform, and then we're going to monetize it and make lots of money." The steps in between are not well laid out.

When we're trying to decide if management is trustworthy, we want to understand its strategy over the long run, whether it involves the reallocation of capital or the need to be more efficient and rethink the supply chain and so on. When we sit down with management, we want to be seen as investors who talk like the board of directors. We want to know how management makes decisions. What are the executives good at? How do they know they're good at it? Why is their business a better business today than it was five years ago? And we might buy into that vision if we can see the pieces. If a company's management tells us that it's doing some short-term fixes, it's telling me that there is no point two in the strategy.

What's frustrating is that managers often have all of the pieces, but their communication is poor because it's targeted to sell-side analysts. Such analysts shouldn't be the audience in the first place, because all they want are the earnings-per-share numbers over the next two years so they can fit them into their spreadsheets. That leads to one of the most amusing and depressing charts of all time, which is what we call the walk-down-to-beatable earnings. Every year, the earnings estimate starts high on the left of the chart, but by the end of the year, it's down there on the right—and the company is, guess what, beating it. We'd rather see the communication and the metrics that the board is talking to management about; we'd much rather have management tell us, "This is how we want to be measured."

McKinsey: *Do you find that companies often take too long to decide to make the kind of change you're looking for?*

Aled Smith: Sometimes we see that alongside a fixation on perfection. That is to say, we often find managers who are paralyzed by too many options. We often hear sad tales of executives saying, "We were holding out for the last euro and now we're selling it at half the price it would have gotten three years ago." The point is they made the decision to sell the business because the capital could be redeployed but underestimated the compounding value of the redeployment.

I would wager that since 2007—when the recent risk aversion started—companies have not been rewarded for the reallocation of capital, precisely because what's being rewarded has been short-term cash-flow generation, not long-term value creation. So if a company has put capital in the ground and depressed short-term cash flow, I would bet that on average its share price has not performed particularly well—even though it's created value. And that's the kind of company we would be interested in.

McKinsey: *Earlier, you mentioned that you like to talk to managers as if you were the board of directors as opposed to just sitting through the typical selling pitch. What's that dialogue like when it's successful?*

Aled Smith: The best company meetings for us, the ones where the light bulbs go on, are those where managers are able to explain the history of the business, its capital decisions, and the key events in the corporate life cycle—to explain why they believe the company is moving in a different direction. Sometimes it also includes a mea culpa: "Here's what we got wrong, here's what we learned, and here's what we're trying to do differently." That helps us see in our terms whether the company has a business model that's not being appreciated by the market—whether there's a real disconnect between the boardroom and the stock market.

I think the biggest message that I would like to give to CFOs is, "Tell us about your business model. Can you, for example, take a big A3 sheet of paper and draw the value drivers of your business?" I'd guess that eight out of ten CFOs can't—and the ones who can, who maybe couldn't three years ago, those are the ones I want to hear from. To me, that's the step-two point in the underpants-gnomes piece.

McKinsey: *How should companies think about what sort of earnings guidance they give investors?*

Aled Smith: If companies tell us how they want to be measured, then I'll take a view if that's appropriate for me or interesting. But if their long-term key performance metrics mean they have some volatility—if a big order came this quarter, for example, instead of next quarter—they shouldn't be beholden to it, and they shouldn't listen to the sell side just because analysts can tell clients the company beat or missed a quarterly

number. Because the sell side has a job to do (which increasingly is being paid for by hedge funds), which is to shift inventory.

Instead, companies have to be strong enough to say, "This is how we run our business," and not hide from it—and they have to be transparent about how they're being incentivized. There's a big problem with incentives in the world today.

McKinsey: *Can you tell us more about the problem with incentives?*

Aled Smith: Whenever we see strange behavior, it's usually because someone's wrongly incentivized. If I am a board director and I understand what you, the management, are doing to create value, then I should set the incentive systems to be aligned with it.

But we find about 70 to 80 percent of incentive systems don't take account of the balance sheet. Managers are incentivized on earnings, on revenue, and on growth, but they are not held accountable for the cost of simple things, such as goodwill on an acquisition. Consequently, their behavior is aligned to their pay, and unfortunately a lot of them get very high pay with no penalty for failure; therefore, we get suboptimal allocation of capital. Managers are being rewarded, but not for creating value.

[1] Robert N. Palter, Werner Rehm, and Jonathan Shih, "Communicating with the right investors," *McKinsey Quarterly*, 2008 Number 2, mckinsey.com.
[2] With around 375,000 investors and more than £215 billion (€259.9 billion; $346.6 billion) under management, M&G is one of Europe's leading active asset managers.
[3] "Gnomes," *South Park*, season 2, episode 17, directed by Trey Parker, written by Pam Brady, Trey Parker, and Matt Stone, aired December 16, 1998, on Comedy Central.

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