MFS® White Paper

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Playing a Bigger Game

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The past few years have been a time of global intensity. We've moved from a global pandemic to a global polycrisis, witnessing multiple crises happening at the same time. We know from history that a problem becomes a crisis when it challenges our ability to cope, manage or even survive.

So instead of talking about markets and all the issues that are out of our control like interest rates, signs of recession and geopolitical risks, this paper looks at how we go beyond coping, rise above the current noise and build resilience. It's about Playing a Bigger Game.

Exhibit 1: What is Playing a Bigger Game?

Comfort Zones	Hunger	Compelling Purpose
Assess	Bold Action	Gulp
Sustainability	Allies	Investment

The framework for playing a bigger game, visualized as the above 9-box grid, helps us look inward and outward, examine our current state, and envision our desired future. It challenges us to question our comfort zones, especially those that have served us well in the past. As the saying goes, "What got us here won't get us there."

In its simplest form, it is a mindset or a philosophy that looks beyond the immediate to consider transformational change, which is not easy to do.

So, we must start by:

- Assessing where we are and how we got here
- Reexamining the purpose of the industry relative to the real world
- Facing our fear of getting it wrong. Our "GULPS"
- Investing our energy differently
- Embracing new allies/organizations who can drive change
- Moving to Bold Action to ensure we can build better outcomes in a world of intense uncertainty

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Who should play?

Everyone can play, but for our discussion, we're focusing on a particular set of players – the 'system' – which refers to those individuals and organizations that operate in the middle of the investment chain, between the end investor and the public companies in which they invest. This includes managers who make investment decisions, advisors who provide guidance, and those who govern the overall process.

The Need for Reconnection

> "What if our actual purpose is closer to our stated purpose? …
> What if we make our center of gravity more human-centric?"[1]
>
> The Big Shift

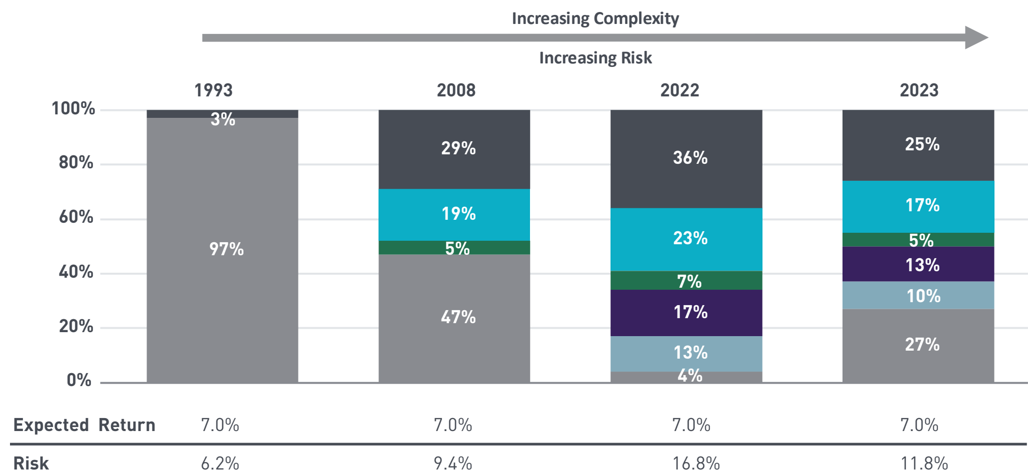
State Street makes a case to play a bigger game in their paper "The Big Shift." They highlight a growing disconnect between the industry's actual purpose (what we do) and its stated purpose (what we say we do). It has become less connected to real world outcomes. They define the industry's stated purpose is to support economic prosperity through the responsible allocation of capital and helping investors achieve their financial goals. This is a two-part purpose, where cracks in alignment are growing.

A Macro Perspective: Where the Misalignment Begins

Over the past 30 years, the investment landscape has dramatically evolved. The Callan Institute's asset allocation study found that investors have to take on greater risk than they did 30 years ago, as shown below.[2]

Exhibit 2: Complexity and risk has increased dramatically

■ Cash ■ US Fixed Income ■ Real Estate ■ Private Equity ■ Smid-cap Equity ■ Dev. Ex-US Equity ■ Large-cap Equity



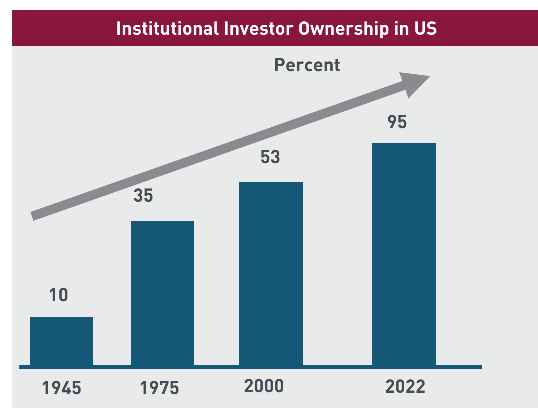
Source: Risky Business. Callan Institute. 2/23/2023. Please see the end of this paper for study methodology. For illustrative purposes only.

This increase in risk-taking has led to greater complexity in asset allocation decisions. It has also forced us into short term accountability focused on measuring past relative returns and leading us to a false sense of risk control.

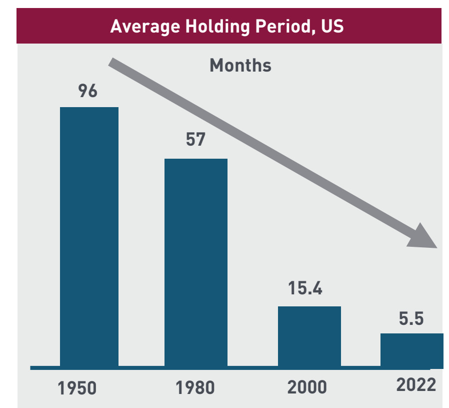
The real misalignment is between time and risk and has created a paradox. On one hand, we're taking more risk, exposing investors and portfolios to greater potential losses. On the other hand, we have less time to manage the risk and pressured to measure short-term performance at the expense of long-term value.

We can perhaps blame it on having low interest rates for far too long. There was nowhere else to go for returns, and as a result the need for professionally managed assets and advice exploded over the past several decades.

Exhibit 3: Increased Institutionalization of Ownership and a Declining Holding Period



Federal Reserve Report 2022 Federalreserve.gov



Average stock holding period NYSE data conducted by Reuters as of 2022

Collapse of Time Horizons

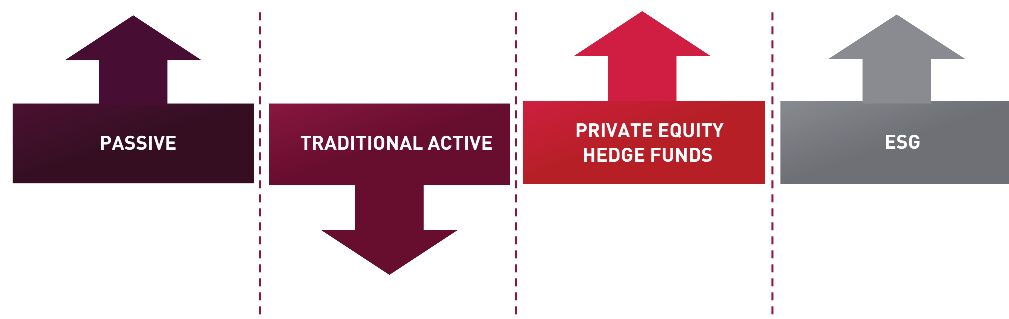
Ironically, as investment expertise significantly grew, capital markets and ownership of companies became dramatically shorter.

In 1945, institutional investors owned 10% of the US stock market. By 2022, that number had grown to 95%.[3] At almost the same time, the average holding period of a stock in the US fell from 96 months in 1950 to 5.5 months in 2022.[4] Even the average holding of a mutual fund is 3.9 years, whereas 30 years ago, that average was 16 years.[5]

We need to understand the impact of these short-term horizons on the entire system, as well as whether such a system will serve us for the future. We must also determine how short termism has impacted end investors' long-term results and public companies' long-term operating behavior.

New Unchecked Risks

Exhibit 4: Investment Approaches to Allocating Risk



Source: "Passive likely overtakes active by 2026, earlier if bear market." Bloomberg Intelligence. March 11, 2021
Source: Alliance Bernstein, White Paper, The (Renewed) Case for Active Investing by Inigo Fraser-Jenkins & Alla Harmsworth

There is no question that the investment landscape has become riskier and much more short term. However, in our attempt to mitigate risk, we diversified return streams and inadvertently introduced new, unchecked risks into the system, specifically the following four:

1. The rise of passive investing, while offering cost efficiency and broad market exposure, has led to a massive concentration of ownership. It has not only affected the dynamics of capital markets but has also raised questions about the value and role of active management.
2. The decline of long-term, well-informed active management has far-reaching implications for corporate governance, shareholder engagement and valuing companies. As more investors turn to passive strategies, the role of active managers as stewards of capital and fundamental to price discovery has been drowned out.
3. The growth of alternative investments with a lack of transparency, illiquidity and higher cost poses another risk. Though they provide diversification and potential for high returns, they also introduce unique risks and complexities that need to be carefully managed.
4. Finally, the messy attempt to address systemic risk through ESG is under intense debate. While ESG factors have gained prominence in investment decision-making, the lack of standardization, transparency, and accountability in reporting and integration has created challenges and all sorts of misunderstandings.

Because of the significant challenge these risks pose to the investment industry, which we will address in more detail below, we need to ask the big "GULP" question - are we simply moving capital or are we investing it? Are we investing in paper or real businesses? The answers will not only shape the future but determine how well we build resilience into our purpose and portfolios. We have an enormous opportunity to look at things differently.

The Impact of Passivication on Public Markets

In 2023, passive funds closed the year with more assets than active funds.[6] The "passivication" of public markets has profound implications for capital markets and investment management, and at what point does the market become too passive? Jack Bogle, the founder of Vanguard and father of indexing, warned about this. He feared concentration risk and the impact on how companies would be run and how markets would work.[7] A study by the US' National Bureau of Economic Research indicated that increased indexing challenges the efficient markets hypothesis and suggested that stocks are insulated against surprises and less able to reflect fundamentals simply because of passive investment flows.[8]

Passive ownership and constant performance measurement relative to benchmarks have also contributed to the distance between investors and the companies their money is invested in. The nonprofit Focusing Capital on the Long Term (FCLTGlobal), which conducts research on how companies and investors can adopt long-term behaviors, looked at the case of Coca-Cola. According to their study, it serves as a stark reminder of the distortions that can arise from benchmark investing: "50% of Coke's investors don't care if they beat Pepsi. They are indifferent to their competitiveness and success. They are not on the Coke team."[9] What they really care about is beating a benchmark, not the value of the companies and how those companies run their businesses for long-term success.

To truly illustrate their point, FCLT segments Coke's investors/owners:

- 28% are retail investors. They are on the Coke team.
- 6% are short-term hedge funds, trading the stock or the price pattern but not thinking about Coke's long term success or failures.
- 25% are passive and own Pepsi too (weights in the index) and so are indifferent to who wins.
- 42% are active managers that are under/overweight the benchmark. Half of them are underweight and hope Pepsi beats Coke.

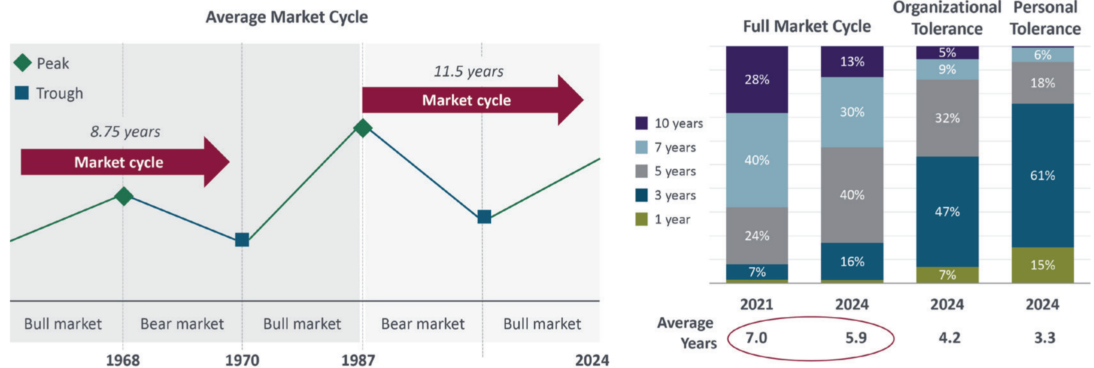
This scenario mirrors many other large public companies, which leaves management teams with a conflicting view of their owners and incentivizes short-term profitability, not long-term value creation. This trend underlines the risk of faulty allocations of capital and alters the game in meaningful ways for both passive and active investors.

The Disconnect in Active Management:

In the realm of active management, a significant disconnect exists between investment objectives and performance measurement. Most active managers aim to generate consistent alpha over a full market cycle. However, the accountability metrics used to measure their performance often do not align with these long-term objectives.

The industry's focus on 3 and 5-year performance periods to assess skill does not align with the historical time period of a full market cycle, which starting in 1970, averaged 7-10 years, but the last three cycles beginning in 1987 averaged 11.5 years. A good majority of investors know this but have little tolerance for negative alpha on a three-year basis.[10] This misalignment underscores the need for a shift in how we measure performance and success in active management. The question is how should we measure the markers to the longer-term destination?

Exhibit 5: Time horizons don’t align



Source: "Defining a Market Cycle," Manning & Napier.
Source: 2024 MFS Playing the Bigger Game Survey (data presented includes 540 Global Institutional Investors)
Q. What is your approximate definition of a full market cycle? Q. What time frame are you given within your organization to generate a positive return (*i.e.*, alpha)? Q: How long are you willing to tolerate underperformance of active managers?

Are Benchmarks the Problem?

The massive rise in indexes is fueling the relative measurement mania. It is hard to believe, but today there are 2.4 million indices vs 43,000 companies. This unbalanced ratio only exacerbates the investment behavior of chasing short-term performance, just moving capital rather than investing in companies. Our accountability measurement system constantly compares short-term past performance relative to benchmark performance, resulting in active managers being commonly hired or fired at the wrong time in the cycle. Rob Arnott, Vitali Kalesnik and Lillian Wu cite in their paper “The Folly of Hiring Winners and Firing Losers,” published in The Journal of Portfolio Management, that chasing past performance costs end investors 80 to 150 basis points annually.[11]

It's Not ESG; it’s Time

Environmental, Social and Governance (ESG) factors have become a hot topic in the investment industry. However, the debate around ESG is mired in political divides and ignores the important economic motives of uncovering economic risks and opportunities.

It is a simple fact that 70 percent of the world’s population has been added to the planet since 1950, having an enormous impact on our natural system.[12] Alex Edmans from the London Business School notes we may be coming to the end of ESG as we know it today, stating “ESG is not special or something separate.... ESG factors are critical to a company’s long-term success. Considering long-term factors when valuing a company is not ESG investing, it is investing.”[13]

Investors are recognizing that this is much more complicated than passive exclusion of ESG factors. Understanding all the risks that can have a material impact to the value of the underlying company is imperative and these investment decisions are active decisions. But as noted before, not every investor is committed to the research required to understand the underlying business or able to withstand the short-term pressure to have long-term conviction.

"The Win-Win That Wasn't"

The shifting landscape of the investment industry is not just a concern for investors. Companies, too, are feeling the pressure to adapt and respond to these changes. In recent years, the traditional paradigm of shareholder primacy – the idea that a corporation's primary responsibility is to its shareholders – has come under scrutiny.

Milton Friedman first introduced shareholder primacy in 1970. The theory states that *"Corporations are run to maximize profits to stockholders and to be highly responsive to their demands, this in turn would benefit all of society"* – what he called a "win-win." But the world and the markets look entirely different today, and according to the economic theorists Leo E. Strine, Jr. and Aneil Kovvali from the University of Chicago, Friedman's perspective is actually "the win-win that wasn't."[15] Analyzing shareholder and stakeholder results, Strine and Kovvali present an abundance of evidence that shareholder primacy has failed. Though they show how the theory *hasn't* worked, what was missing in their argument were reasons why it *couldn't* work:

- The low cost of capital and the extended rise of risk assets.
- The rising level of passive since 1970, every company gets financing by simply being in the benchmark.
- The move to a short-term measurement system built on beating benchmarks.

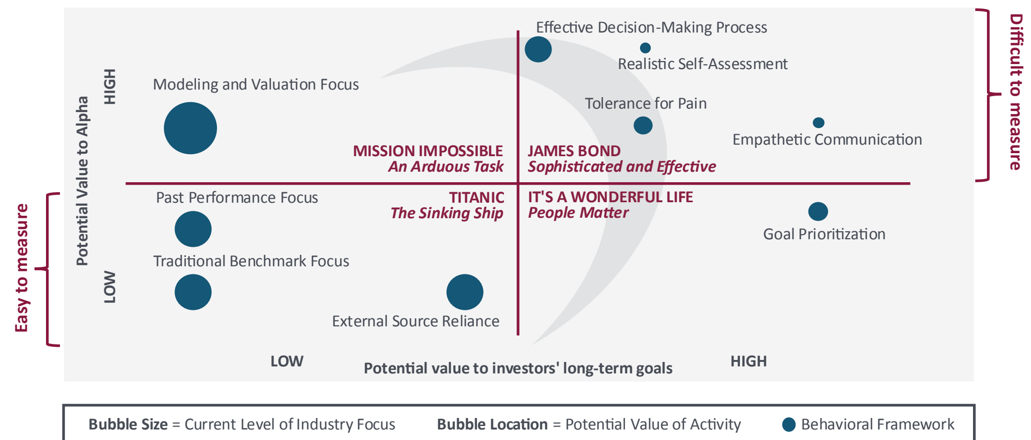
It is highly unlikely that Friedman ever imagined any of these, and now consumers, regulators and investors are demanding a stakeholder view of their businesses. And companies that successfully navigate this shift can reap significant benefits, as well as seeking resilient returns for long-term investors, this is not new.

Build Trust

In 2015, State Street conducted another global study on the asset management industry called the "Folklore of Finance," and its main theme is more applicable now than when it was written.

They argue, as illustrated in the below chart, that the industry spends too much time on the things that don't in fact add value to generating long-term returns or meeting investors' long-term goals.

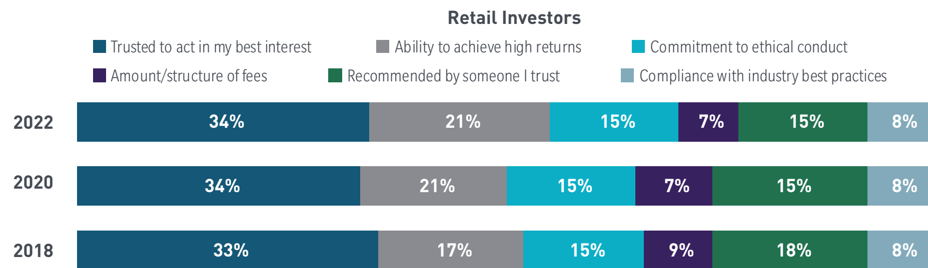
Exhibit 6: The Industry is Focusing on Things That Don't Add Value



Source: "The Folklore of Finance," State Street Center for Applied Research, 2015.

Further evidence for better alignment is needed. The CFA Investor Trust survey consistently shows that end investors care more about trust than short-term results, placing twice as much importance on an asset manager that acts in their best interest.

Exhibit 7: Most important attribute when hiring an asset manager



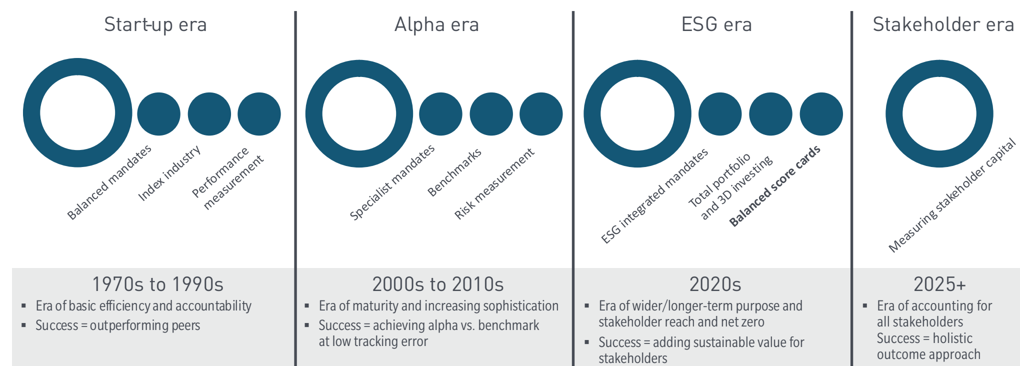
Source: CFA Institute, 'Enhancing Investors' Trust: 2022 CFA Institute Investor Trust Study,' trust.cfainstitute.org. Please see the end of this paper for study methodology.[15]

Bold Action is Required – Rethinking Measurement

So what if we had new standards to ensure better accountability and alignment? How should we measure long term? Today, we all say we are long-term investors, but industry behavior is not aligned with those words. A study done by Create Research showed that 70% of institutional investors currently measure performance based on relative returns versus 30% absolute. Many think this will flip in the future: 70% will measure absolute return versus 30% relative, which could be a healthy rebalancing of objectives and risk management. The industry could instead begin to measure relative to the desired long-term outcome of the end investor and incorporate new metrics of long-term behavior that drives resilience in a portfolio rather than chasing benchmarks in the short term that only drive higher levels of risk in portfolios.

WTW (formerly Willis Towers Watson) described the evolution of performance measurement, noting that we are no longer in the start-up era but now living in the messy middle, caught between the alpha era and now the dysfunctional ESG era. In the face of this, WTW looks to a new stakeholder era, in which more factors of performance are included, and there is innovation and development focused on how to measure long-term value creation.

Exhibit 8: Moving From Short-term Outperformance to Long-term Value Creation



Source: Thinking Ahead Institute and WTW. 2022

Many large institutions are evolving as well, especially those that have brought management in house, they recognize the flaws in the current system and understand how important accountability is, both internally and externally. This kind of transformation could be a huge step forward in creating better alignment and addressing the unchartered territory of systemic risks that are now unavoidable investment risks, like ESG, cyber-attacks and even aspects of artificial intelligence.

Bold Action: Real Life Examples

The concept of bold action is not just theoretical; it is being put into practice by organizations across the investment industry. Two examples stand out - the Long-Term Stock Exchange (LTSE) and Focusing Capital on the Long Term (FCLT).

The LTSE, founded by Eric Ries, author of The Lean Startup, received SEC approval in 2019. It represents a radical departure from traditional stock exchanges. The LTSE is based on five principles, including long-term thinking, alignment of interests, and stakeholder orientation. On the investor side, they partnered with the Stanford Center for Long-Term Investing to analyze 75,000 active investors (mutual funds, hedge funds, sovereign wealth funds and pension funds), scoring them high, medium, or low on long-term behaviors. They aim to match long-term investors with companies that are managed for long-term success. The LTSE represents a bold attempt to reshape the capital markets ecosystem and to provide a platform for companies that prioritize long-term success.

The research conducted by FCLTGlobal, mentioned previously, has shown that when public companies align their investor capital with their long-term strategies, it can have a meaningful impact on their long-term financial results. This alignment can lead to higher return on invested capital (ROIC), higher allocation to research and development (R&D) and capital expenditure (CapEx), and a reduced demand for short-term guidance or estimates.

These examples demonstrate that bold action is not only possible, but also beneficial. They show that when companies and investors align their strategies and behaviors with a long-term perspective, they can create significant value for themselves and their shareholders.

Why take this on?

For MFS, what drives us, that proverbial elephant in the room, is twofold:

- What is the value of long-term active management?
- Are we aligned to Purpose?

Over the past 100 years, MFS has learned valuable lessons that have only reinforced the importance of our commitment to long-term returns through active management and the idea of transformation. We know bold action is required, and as active managers, our job is not to follow the herd but to ensure we are aligned with our purpose and the dual purpose of the industry. We can lead and drive economic prosperity by playing a bigger game so investors can achieve their financial goals. Our history has taught us we need to be an organization built to change with investors and for investors. We intend to innovate and partner on closing the gaps in alignment to build trust in what we do for the future.

Conclusion

The Bigger Game can't be played alone. It will take a collective shift in how we view value and how we operate as an industry. But we each can start by moving out of comfort zones and challenging the current norms, choosing innovation instead of indifference and building resilience in our current system. Investors and our investable markets count on us to recognize misalignments and to change, clear artificial barriers that hold us back from putting their money to work responsibly.

Endnotes

[1] Kastrapeli, Mirtha, Hudson, Jem, Kheddache, Mimmi Jendeby and Palanza, Philip, The Big Shift: Finding a New Center of Gravity in the Investment Industry (September 2019). State Street.

[2] The Callan Institute. "Risky Business." https://www.callan.com/blog-archive/risky-business-2023/ The Callan Institute used their proprietary capital market projections to conduct asset allocation studies for clients in order to determine the risk associated with portfolios that are designed to generate an expected return. Callan has an optimizing tool to find what they call the "efficient frontier" or the right combination of assets to provide the highest return for the lowest risk.

[3] Federal Reserve Report 2022 Federalreserve.gov.

[4] NYSE data conducted by Reuters.2022.

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[15] Coalition Greenwich surveyed 3,588 retail investors and 976 institutional investors in October and November 2021 from 15 markets across the globe. Retail investors were 25 years or older with investible assets of at least USD100,000, except in India, where the minimum asset level was INR5,00,000 (5 lakh rupees). Investible assets include retirement plans, stocks, bonds, mutual funds, and other financial instruments. The age distribution was spread across generations and the breakdown by gender was 62.9% male, 37.0% female, and 0.1% for nonbinary individuals and those who prefer not to disclose. Institutional investors included individuals responsible for investment decisions with assets under management of at least USD50 million from public and private pension funds, endowments and foundations, insurance companies, and sovereign wealth funds.

[16] Rajan, Amin. Passive Investing: Reshaping the Globa Investment Landscape. CREATE-Research. 2018.

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