

The *Ambachtsheer* Letter

Research and Commentary on Pension Governance, Finance and Investments

Letter # 237

October 2005

ERADICATING 'BEAUTY CONTEST' INVESTING:

WHAT IT WILL TAKE

"Companies need to change the nature of their dialogue with stakeholders. That means first identifying investors who will support a company's strategy, and then attracting them."

Ian Davis
McKinsey Quarterly
April, 2005

The Ugliness of 'Beauty Contest' Investing

John Maynard Keynes penned his famous diatribe against 'beauty contest' investing 70 years ago. He characterized the nature of institutional investing as akin to a charade, with the aim being to correctly guess which stocks investors would find most attractive 3-6 months from now. Last month we lamented that, 70 years later, there is little new under the sun. There is still far too much 'beauty contest' investing around today, and not only in the retail-oriented, unsophisticated world of mutual fund investing. It continues to be a systemic problem in the supposedly more sophisticated worlds of pensions, insurance, and foundations too.

'Beauty contest' investing is not just a harmless sport played for the amusement of the people who have situated themselves between millions of individual investors and their money. At a micro level, it is a zero-sum game minus material, value-destroying leakages in the form of intermediary marketing, management, and transaction costs. At a macro level, 'beauty

contest' investing promotes 'short-termism' in decision-making, a potentially even greater destroyer of economic value. 'Short-termism' leads to the misallocation of society's savings into unproductive short-term uses, rather than into wealth-creating, long-horizon capital formation. For example, in a recent survey of 401 financial executives, the majority indicated that they would sacrifice value-creating projects if it meant falling short of the current quarter's consensus earnings, or break up a smooth progression of reported earnings. (Graham, Harvey, Rajgopal, "The Economic Implications of Corporate Financial Reporting", NBER, 2005).

All this gets us to the goal of this *Letter*. It is to set out the necessary conditions for finally eradicating 'beauty contest' investing from the face of the earth.