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Short-term orientation of equity market creates time arbitrage opportunity for long-term investors

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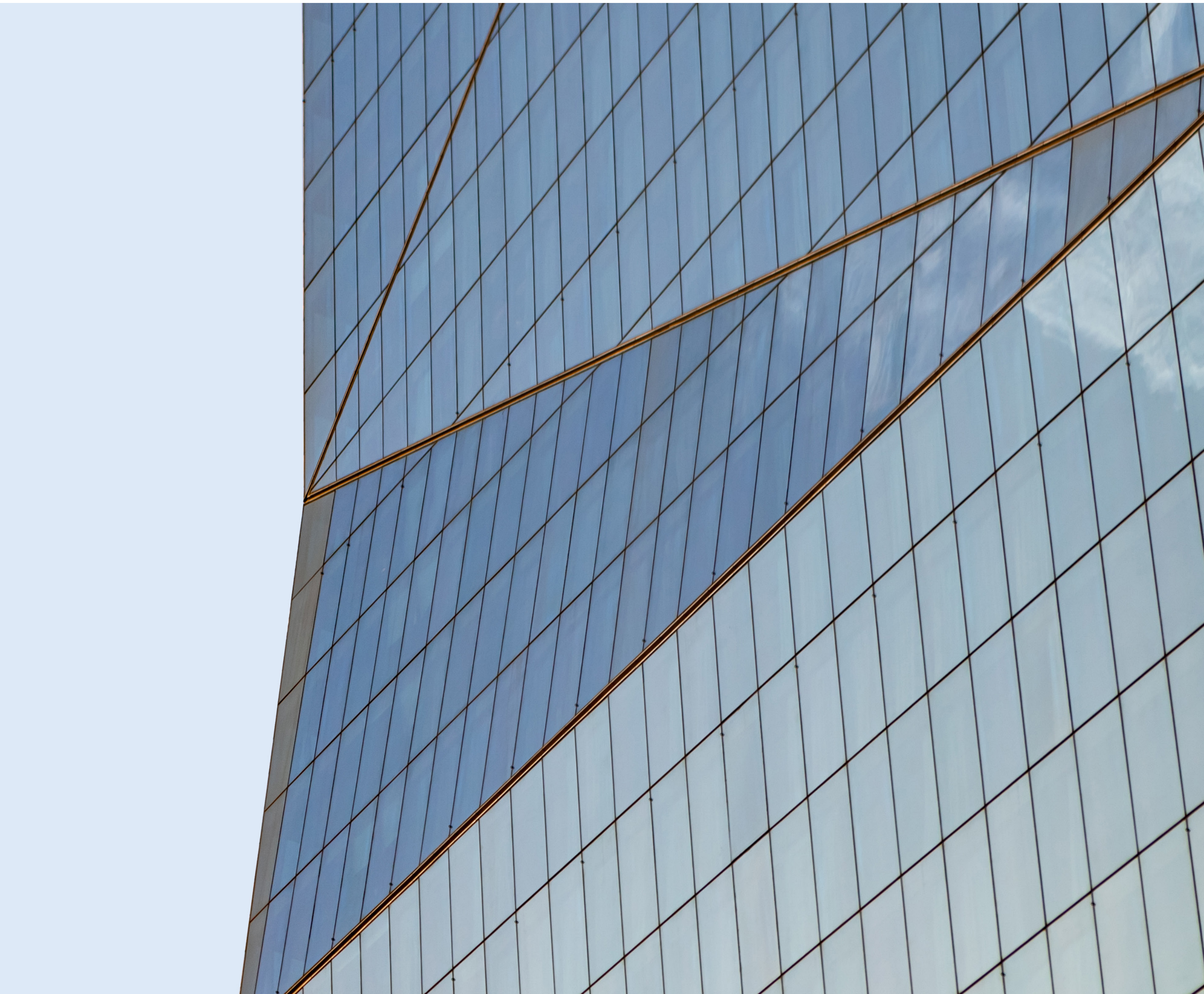


Summary

- The average holding period of equity investments has shortened considerably from 9 years in the mid-1970s, to slightly more than 6 months in 2025
- Daily trading volume in the US has nearly tripled over the past decade, with algorithmic trading now dominating the market resulting in a persistent overreaction to events, headlines, and macro developments
- Majority of sell-side commissions are paid for by hedge funds leading to short term skewed research
- The vast majority of estimates published by the sell-side are provided in the first four forward quarters, resulting in trade calls that have been reduced from years to weeks or months
- The "2 and 20" hedge fund compensation structure creates a market dominated by investors incentivized to meet annual goals
- Longer-term focused companies outperform their short-term peers on several important financial measures
- Earnings growth can be used as a tool to assess a long-term orientation of companies and is under penetrated in international markets

Background

Many investors have heard Warren Buffet's sage investing advice, "If you aren't willing to own a stock for 10 years, don't even think about owning it for 10 minutes". The Oracle of Omaha's approach to investing is time-tested, but market dynamics have changed considerably since he first began investing in the mid-1950s. Given the current structure of equity markets, we believe there is a time arbitrage opportunity available to investors willing to look beyond the transitory concerns that dominate today's trading.

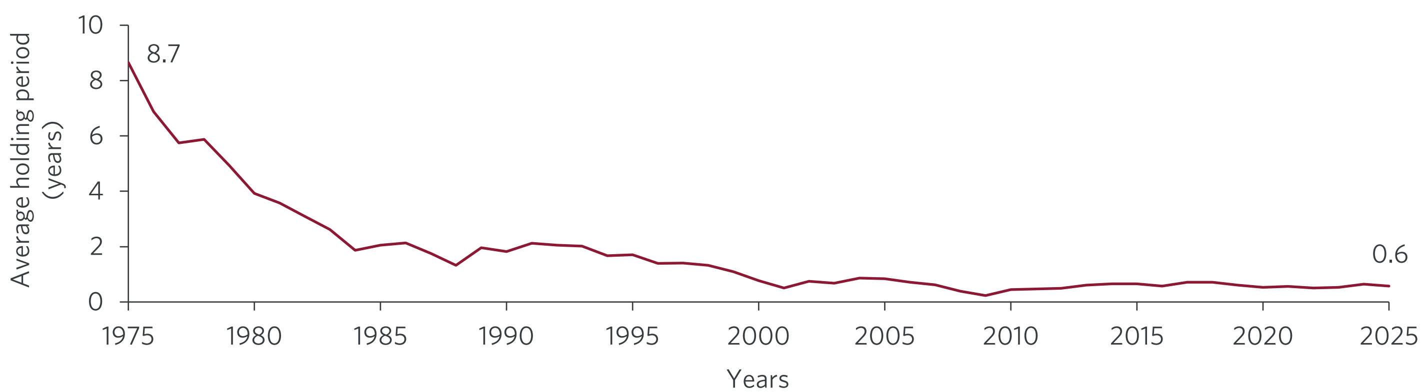
This paper examines the following:

1. Equity holding periods
2. Market structure and algorithmic trading
3. Sell-side commission structures
4. Incentivization of asset managers
5. Performance of short vs. long-term oriented companies
6. Using the sustainability of earnings growth as a tool for long-term assessment

Investor holding periods have shortened considerably

Investors have become increasingly short-term oriented over the last few decades. As an example, the total market US total return index tracks the largest 1,000 companies in the US, including both retail and institutional investors. Though we are international managers, US market data has been used throughout the paper as it typically provides the most robust datasets given their longer index track records, and transparency and accessibility of information. Using both market capitalization and turnover data for the index, we can determine the average holding period of investors.

Total US market: Average holding period

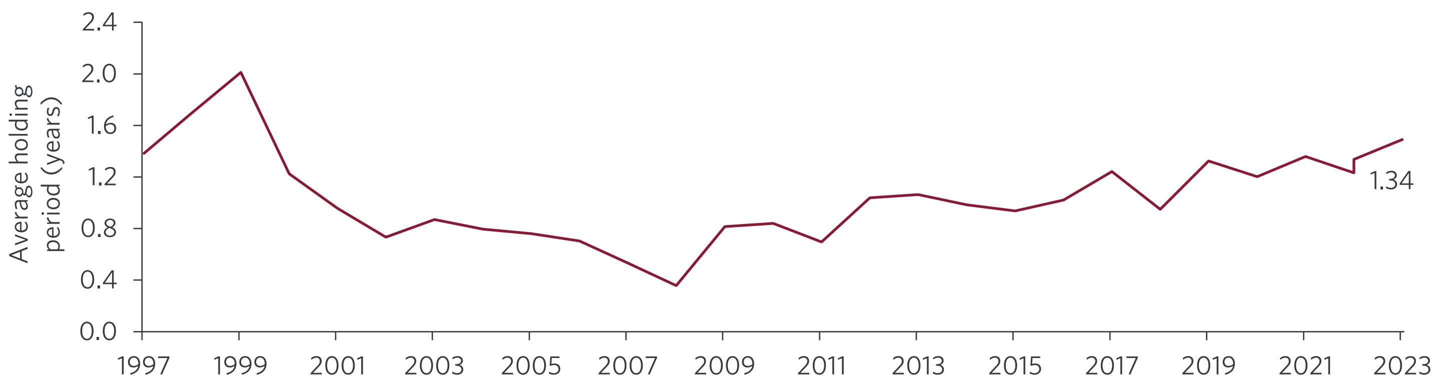


Source: Refinitiv Workspace as at March 14, 2025. Stock market holding period is derived through calculating 1/turnover ratio. The turnover is ratio is the value of equities traded/market capitalization. Index used: TOTMKUS.

In the US, average holding periods have decreased from 9 years in the mid-1970s to just over half a year in 2025. While some of the decrease can be attributed to greater retail investor market accessibility through discount brokerages, institutional managers were also shorter-term focused. Analyzing institutional managers in the United States, the average holding period from those disclosing turnover statistics was around 2 years at the end of 2024[1].

Over the last 30 years, international markets didn't fare any better. Using the MSCI EAFE®[2] Price Return Index given its longer track record, the holding period averaged just 1.06 years since 1997.

MSCI EAFE®[2] Index: Average holding period



Source: Bloomberg as at April 16, 2025. Stock market holding period is derived through calculating 1/turnover ratio. The turnover is ratio is the value of equities traded/market capitalization. Index Used: MSCI EAFE®[2] Index.

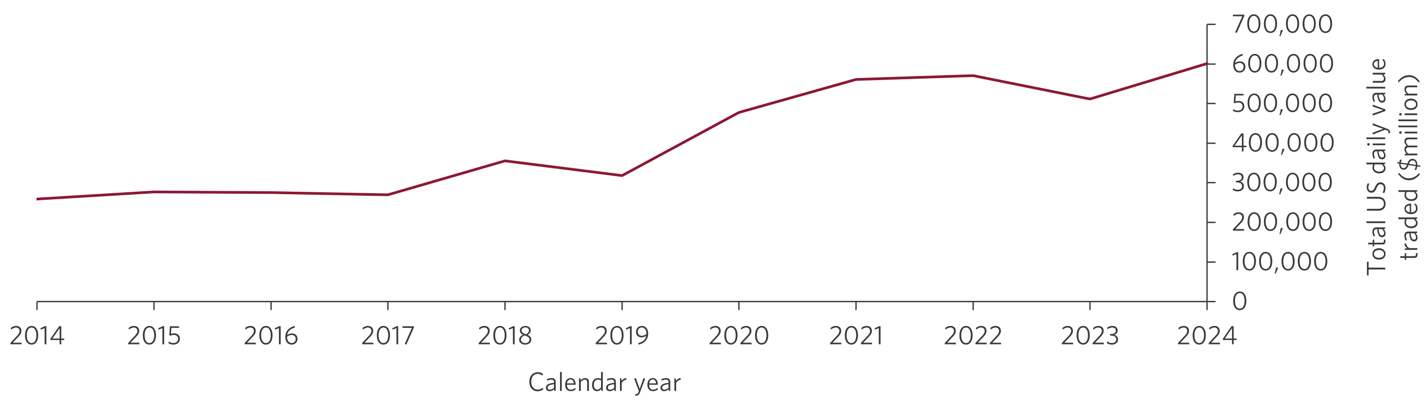
In 2024, international markets had double the holding period in comparison to US markets, but were just as short-term focused. Analyzing institutional managers in both ACWI ex-USA and EAFE®[2], the average holding period from those disclosing turnover was very similar to US markets at 2-years[1]. Fundamental managers in both the US and international markets held stocks longer than the broader market, but significantly shorter than in the 1970s.

Algorithmic trading contributing to shorter-term holding periods

The movie Wall Street, made in 1985, showcased human brokers executing buy or sell trades on behalf of their investors. What appeared to be a fast-paced environment during the 1980s is considered slow and antiquated by today's standards, especially when involving the human-to-human interaction. Technology, more specifically algorithmic trading, has contributed to the shorter holding period among market participants.

Over the last 10 years, the value of US daily trades has increased by close to three times, increasing from around $258 billion in 2014, to $601 billion by the end of 2024[3].

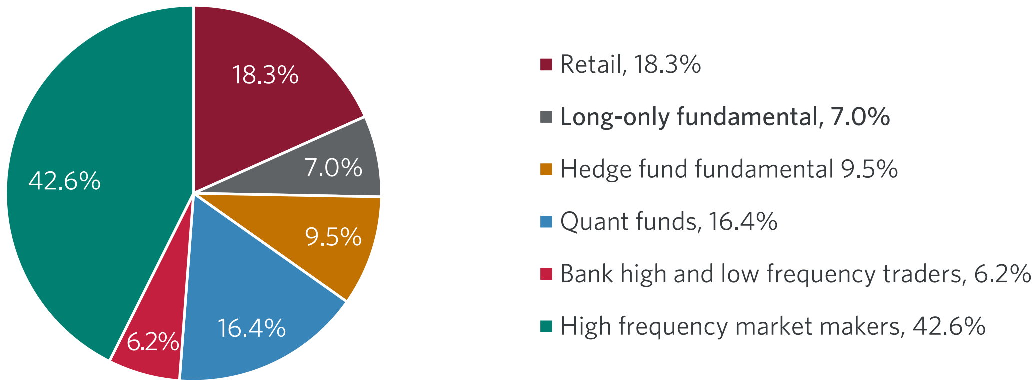
Total US daily value traded



Source: Bloomberg. As at December 31, 2024.

Despite the increase in total market volume observed over the last decade, there has been a material decrease in fundamental investors as a percentage of market participants. In 2003, more than 80% of the average daily traded volume of the market was non-algorithmic or rules-based[4]. Today, it is a small fraction of total trading.

Trader type (% of total trading)



Source: Bloomberg as at December 31, 2024.

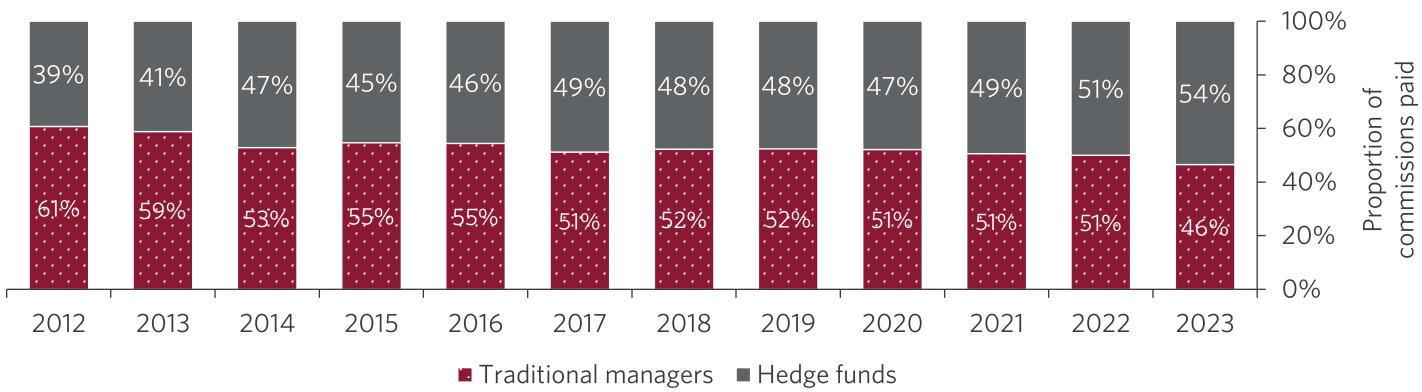
Long-only, fundamental investors comprise just 7% of total market daily value of trading, and rules-based, high frequency, or hedge fund traders now comprise 75%, with the remainder associated with retail trading[3]. To put it in perspective, the average holding period for a high frequency trader can be as little as seconds to minutes. As such, there is a persistent reaction to events, headlines, and macro developments associated with rules-based trading that wouldn't impact the thesis of a fundamental investor.

Commission structures favour short-term investors

The sell-side has played an important role in increasing market efficiency, reducing informational asymmetries and providing varying perspectives on the bull and bear cases for covered companies. However, sell-side research has increasingly become more short-term focused as a result of the structure of the market and the make-up of its primary commission payers.

From 2015 to 2024, the number of brokers in the US was largely cut in half, and from 2012 to 2023 overall commissions paid to the sell-side went from $10.2 billion in 2012, reaching a height in 2015 at $10.8 billion, decreasing to $7.1 Billion in 2023[3]. This means that fewer commission dollars were paid to a more concentrated list of sell-side brokers competing for business. Eager to maintain share, sell-side research has catered to a different composition of market participants.

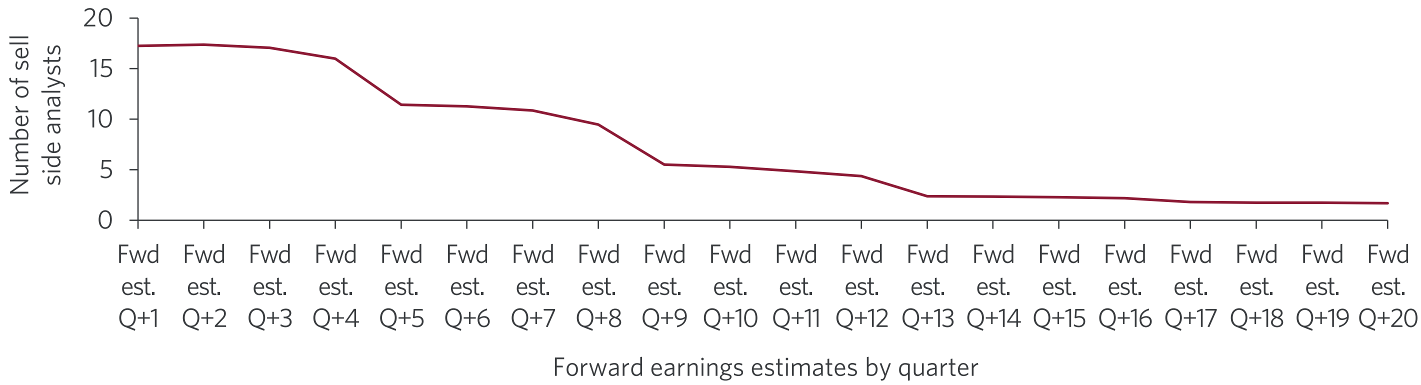
Commissions paid: Traditional managers vs. hedge funds



Source: Bloomberg as at December 31, 2024.

Traditional asset managers went from paying the vast majority of commissions to only a fraction. In 2012, traditional managers paid 61% of commissions vs. 39% by hedge funds, compared with 46% vs. 54% of traditional asset managers vs. hedge funds respectively in 2023. In a world where the number of brokers are rapidly shrinking, there is an inherent incentive to cater to the model of investor that pays the majority of commissions. This is reflected when analyzing large-cap companies within the S&P 500 Index, and the forward earnings estimates released by the sell-side.

S&P 500 Index: Average number of published sell-side forward estimates for large cap companies



Source: Bloomberg as at March 31, 2025. Large cap companies were identified as having a market capitalization greater than $50 billion.

The vast majority of estimates published by the sell-side are provided for the first four forward quarters. By the beginning of year 3, just 17% of the original sell-sides analysts, on average, provide an estimate. Highlighting this further we can look at a company like Taiwan Semiconductor Manufacturing Company. As at March 31, 2025, from forward quarters 1 to 4, there were 35 analysts who provided an estimate, falling to just 9 in the first quarter of year 3[3]. Trade calls by the sell-side have been reduced from years to months, resulting in a persistent over-reaction to short term issues. For long-term investors who perform their own independent research, buy businesses rather than stocks, and look past the short-term, this creates favourable environment for investing.

Investors are increasingly incentivized to prioritize shorter time frames

The compensation structure for portfolio management teams plays a critical role whether they will seek long-term returns. The CFA Institute has long sought to reduce agency costs, and for fundamental managers to pursue approaches that are aligned with the interests of investors. In 2020, they published a paper entitled, "Short-termism revisited: Improvements made and challenges in investing over the long-term". A panel of authors concluded that investors should ensure that their performance was benchmarked over a mix of current and multi-year performance horizons[5]. In addition, they believed that better asset managers tended to have less portfolio turnover, and could easily incorporate deferred compensation incentive structures because they knew they would eventually get paid[5]. Deferred compensation and the prioritization of longer-term periods results in managers who don't take undue risk to maximize short-term gains.

In contrast, traditional fees for the hedge fund industry are notoriously stated at "2 and 20". 2% is the management fee calculated on a fund's net asset value (NAV), and 20% represents the additional fee for profits generated. Both are typically calculated over a 12-month period. Since rules-based, high frequency, or hedge fund traders account for 75% of market activity, as mentioned earlier, this creates a market, dominated by investors incentivized to meet annual goals. For example, a hedge fund experiencing negative returns, or under their high water mark, at the beginning of November is more incentivized to generate profits in the final 2 months of the calendar year than reducing agency costs or generating long-term returns. Managers may deviate from their intended investment approach, style, or risk constraints in order to avoid losses or achieve annual incentives. This naturally creates a short-term orientation for the overall market, and generates opportunities for managers with longer-term or deferred incentives.

Long-term oriented companies perform better over time

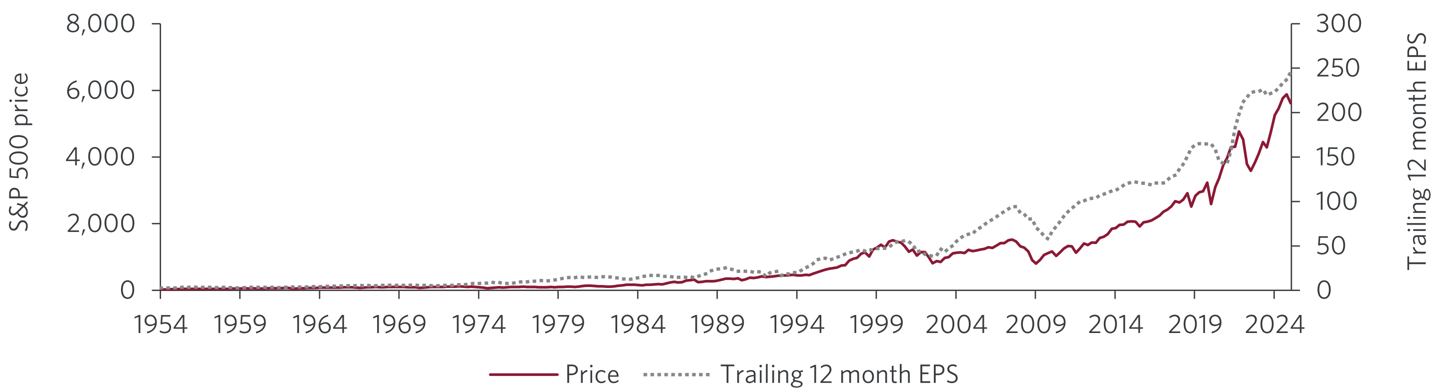
The previous section focused on the shorter-term incentivization of investors. Responding to the incentives of their investor base, a byproduct of this is the increasing pressure on corporate management teams to prioritize short-term performance, such as hitting quarterly earnings expectations, rather than long-term value creation. Companies can engage in advantageous accounting practises, reduce research and development, forgo accretive projects, or delay hiring in an attempt to boost short-term earnings. The study, "Evidence and Implications of Short-termism in US Public Capital Markets: 1980-2013", found that US public firms experienced a market-wide contraction of firm time horizons[6]. Little investment in R&D or capital equipment, ownership by high turnover transient investors, and large share repurchases (an investment that does not fuel future economic growth) all correlated with increased short-termism[7]. Implicit in this research is that short-termism by companies is a reaction to an investor base increasingly focused on quarterly earnings and other short-term metrics.

The study, published by the Harvard Business Review, also found that long-term focused companies outperformed their short-term peers on several important financial measures, and created significantly more jobs. They delivered 47% higher revenue, 36% higher earnings, 81% greater economic profit, and were 50% more likely to be in the top quartile or decile of their peer group[8]. The research highlights that the assessment of long-term oriented businesses and whether they succumb to quarterly pressures, is a critical element when investing. Fundamental investors who have a better understanding of corporate strategy through extensive due diligence and in-person management meetings can more easily identify companies exhibiting corporate long-termism.

Using growth as a tool to identify long-term oriented companies

Assessing the sustainability of earnings growth can help investors maintain a long-term focus. Value generating projects that lead to consistent earnings growth take time to implement, and capable management teams to execute. Consistent earnings growth is also one of the most impactful drivers of stock market returns over the long-term.

S&P 500 Index vs. earnings



Source: Bloomberg as at December 31, 2024.

From 1954 to 2024, the S&P 500 trailing 12 month earnings per share (EPS) was almost perfectly aligned with the trajectory of the S&P 500 Index. This implies that earnings and growth should be coveted universally by investors given the high correlation with stock appreciation. However, annual compensation incentives changes the perception of valuable companies. A long-term investor may believe a premium multiple is warranted for top-in-class companies given their ability to grow earnings and free cash flow. However, if a fund manager is compensated on annual returns, a premium multiple represents potential downside risk over the short-term and the manager may avoid the security. Stated differently, a company that has the time to grow into its multiple is valuable only for the patient investor. This is why growth forces a long-term time horizon, and why many opportunities exist despite the excellence of these businesses.

Analyst evaluation of earnings growth is even less common in international markets. For example, 50% of assets in the US equity market are managed with a growth tilt[1]. In comparison, just 20% to 25% of international equities are managed using a growth oriented approach[1]. This means that international markets are under penetrated when it comes to assessing earnings growth for stability and predictability, and in-turn, provide an even larger opportunity for the patient investor.

Patience creates a time arbitrage opportunity

Taking a patient approach, and capitalizing on time arbitrage is at the core of what we implement within the CIBC International Growth Strategy at CIBC Asset Management. We are a 9-person team which has been managing international equities for over 20-years. We use a bottom-up, high-quality core approach with a growth bias combined with a disciplined valuation methodology. Many investors inherently wait until controversy passes before initiating positions aligned to their long-term thesis, but we are experts at stepping into controversies that we believe will resolve over time. We generate independent research outside of the sell-side, conduct extensive due diligence, and hold companies indefinitely creating a unique advantage. We maintain a catalogue of well-vetted quality growth stocks, which is continuously monitored for dislocations in share price. It allows us to focus completely on assessing if a dislocation event is structural or temporary. By not being confined by quarterly or annual performance requirements, which limit hedge funds and other types of investors, we can afford to be patient. We invest in the under penetrated quality growth area of international markets allowing for a unique understanding of compounding growth opportunities and forcing a long-term view. All of this culminates in a strategy that takes advantage of the time arbitrage opportunity evident within markets. We believe that allocators should consider the CIBC International Growth Strategy when looking for a long-term, core approach.

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At CIBC Asset Management, we believe that every customized investment solution begins with research and rigour. We specialize in a variety of investment solutions such as equities, fixed income, currency management, liability-driven investments, asset allocation, and responsible investments.

Across a spectrum of investment solutions, we commit to best-in-class research. Dedicated sector and regional analysts focus on industry research and security-specific idea generation. Our investment professionals leverage deep and diverse expertise by sharing proprietary research across asset-class teams. By sharing insight across asset class teams, we maximize opportunities to add value to our client portfolios.

Contact us any time

To learn more about CIBC Asset Management and our investment solutions, please contact your CIBC representative. For more insights, connect with us on LinkedIn.

† Daniel Delany and Matthew Scherer are investment adviser representatives with CIBC Private Wealth Advisers Inc., a sub-adviser to the CIBC International Growth Strategy offered by CIBC AM.

1 eVestment Alliance as at December 31, 2024. Data considers all United States equity institutional managers disclosing turnover statistics as at Q4 2024.

2 EAFE" is a registered trademark of MSCI Inc., used under license.

3 Bloomberg as at December 31, 2024.

4 Jefferies "When the market moves the market". 2019, Shannon Murphy, Lily Calcagini, Anthony Pallone

5 https://rpc.cfainstitute.org/sites/default/files/-/media/documents/article/position-paper/CFA-SHORT-TERMISM_Web.pdf

6 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2837524

7 https://msb.georgetown.edu/news-story/short-term-thinking-us-markets/

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