The value of ownership

The RBC Global Equity team

Improving outcomes through engagement

It's been said that the fastest car in the world is a rental. That might not always be true – unless, of course, your local Avis has a Bugatti Veyron on its books – but the statement does reflect how people feel differently about the assets they rent compared to the ones they actually own. A rental driver returns the keys and doesn't have to worry about the amount of tread left on the tires or how much wear remains in the brake pads. But the car owner is much more likely to care about such things.

The significance of ownership

It's peculiar how many investors don't consider the long-term condition of the assets they own. Perhaps it's because most owners are not owners at all, but are just renting a share certificate for a short period of time. "High-frequency trading" strategies are probably the most extreme example of this and have invited a lot of controversy. Opinion is divided as to whether two million quotes a second on U.S. stock exchanges represent an improvement in price discovery and market efficiency, or whether they simply exacerbate market volatility.

Passive investment strategies are arguably similar. These attract investors wanting exposure to an index or "asset class," not to individual businesses. Aggressive focus on a short-term trade is replaced by an apathetic, hands-off approach. Indeed, once the basket of shares has been bought, a passive investor will intervene as little as possible in order to reduce trading costs. Such strategies have grown quickly, accounting for 18.4% of the total net assets of U.S. mutual funds in 2013, up from 11.4% 10 years earlier.

Whether it is high-frequency trading or passive investment strategies, it's clear that neither option does anything for improving the quality of the underlying asset – the business.

Businesses: A source of real wealth generation

Yet businesses are instrumental to the way we live our lives. Just look at the things around us – the cars we drive, the phones we use, the foods we consume – they're all provided by businesses. This isn't new. In 1776, Adam Smith, the father of modern economics, wrote about the power of commerce to unwittingly improve lives: "It is not from the benevolence of the butcher, the brewer or the baker that we expect our dinner, but from their regard to their own interest." The separation of daily management from ownership, enabled by the creation of joint stock companies, has allowed businesses to become larger and much more complex since then, but the principles that Smith observed over 200 years ago are just as relevant today. Individuals are collaborating, combining their labour, capital and ideas to generate outputs that are worth more than the sum of the individual inputs.

This is real wealth generation that's shared broadly with the employees who make an income, the suppliers who earn a livelihood and the customers who enjoy the goods and services provided. How appropriate that Smith should have entitled his magnum opus The Wealth of Nations, given how broadly the business benefits are shared across the community.

Owner engagement is critical

Of course, things change. Businesses compete and, at any time, a business may find a more productive way to combine labour and capital to add value that leads to its enrichment at the expense of competitors. So not all businesses will do well all of the time. A struggling business may impact employees, suppliers and customers, but it's the owner who stands to lose everything if it fails. This means owners are not only ultimately responsible for ensuring their business can compete and therefore generate wealth, but are also incentivised to do so.

But in a world that's increasingly divided between highly vocal investors looking for quick gains and mute passive investors disengaged from the businesses they own, maybe it's time to ask whether that division between the owner and day-to-day management is still operating in a way that increases overall wealth. Smith may well recognise the trader's pursuit of a quick turn as acting in their own self-interest, but when it informs the behaviour of day-to-day management, the business's long-term interests end up being compromised. Like an insecure parent, managers will pay attention to pleasing the whims of the most vocal owners at the expense of the business's long-term health. This is borrowing from the future to over-earn today. Whatever the form the borrowing takes – be it from employees or suppliers, or from the firm's assets or its environment – it simply creates a bigger problem for the future that can sometimes be deferred, but can never be avoided.

The business's long-term health, and hence the interests of employees, suppliers and society, is best served by owners who are engaged with it and care about maintaining its health and vitality, not just over the short term, but over the long term as well. This requires a shift in time horizon and greater engagement. However, the good news is that, done properly, it can increase overall returns for owners while lowering risk.

Three strategies for owners to increase returns, lower risks

There are three main ways in which owners can increase returns while lowering risks:

1) **By avoiding unnecessary costs.** These include both the transaction costs of a high-turnover portfolio as well as the loss of capital that come from owning an under-invested business when it struggles to compete due to past "borrowing."

2) **By better knowing what they own.** Actively engaging with a business and accepting the responsibility of ownership deepens knowledge that will enable a shareholder to better judge the business's prospects and hence value it more accurately.

3) **By compounding returns.** A successful business competes effectively, expands market share, reinvests in new opportunities and operates in a responsible manner, allowing it to generate funds that can be either shared with owners or used to sustain future activity.

The benefits of engaged ownership

Of course, positive results can't be guaranteed and much will depend upon successful and disciplined implementation. But done effectively, investors who engage with the businesses they own may not only succeed in being better stewards of capital, but may also help sustain better businesses. Even though the rental driver may miss the quick thrills of a fast ride, in the long run, observing the speed limit is better for the car, for the driver and certainly for others on the road. This has to be in all of our interests.

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Jeremy is part of the global equities team at RBC Global Asset Management based in London. The team runs high-conviction portfolios investing in select global companies that have strong competitive dynamics, including environmental, social and governance credentials. Jeremy has over 20 years of investment experience and is a qualified chartered accountant.

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