OUTCOMES BEYOND PERFORMANCE

PLAYING THE LONG GAME: INVESTING EFFECTIVELY BEYOND THE MARKET CYCLE

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HERMES INVESTMENT MANAGEMENT

> If you aren't willing to own a stock for ten years, don't even think about owning it for ten minutes.

Warren Buffett
Chairman's Letter, Berkshire Hathaway, 1996

Many commentators are now in agreement that the investment industry is firmly embedded in "the era of quarterly capitalism"[1] and as a consequence has become too focused on short-term, benchmark-relative performance outcomes, far removed from what beneficiaries actually require of asset managers. As the push for long-term investing gains momentum, short-termism is not only seen as delivering sub-optimal returns for asset owners, but also more widely for the financial ecosystem at large. Misaligned, short-term corporate behaviour also leads to insufficient levels of engagement to ensure that stewardship responsibilities are properly used for the betterment of society as a whole. Yet outside the private market world of private equity, private debt, property and infrastructure investing, true long-term investing is still extremely rare when it comes to active management in the public markets. And that is in spite of the efforts of numerous industry bodies, (the 300 Club, Focusing Capital on the Long Term, the Thinking Ahead Institute, to name just a few), to bring this issue front and centre.

[1] Haldane, A G, (2010), "Patience and Finance", *speech given at the Oxford China Business Forum*, Beijing.

Much ink has been spilled as to the 'why' we should be interested in long-term investing, and aside from a brief overview of the key reasons, we don't propose to add to that literature. Instead our intention is to focus this paper on 'how' long-term investing should be done, a question to which not much attention has yet been given. Is it as simple as extending the horizons and holding periods of existing portfolios, or does such an initiative require something more, a shift in mind-set, change in culture, a reframing of collective responsibilities? We will also take a look at the question of whether every asset manager is suited to long-term investing, and what shape such mandates might sensibly take. We will conclude by proposing some common sense methods to measure their success or otherwise.

THE 'WHY' OF LONG-TERM INVESTING

John Kay's review[2] (to ensure that equity markets support long-term growth) raised deep and far-reaching questions not only about the purpose and structure of today's companies, but also more broadly about the value of asset managers and asset owners as they invest their beneficiaries' capital. Additionally the G20 and the OECD have picked up the theme of long-term investing in their agendas of the last several years.

A clear link has been drawn in the academic literature between underinvestment, economic inefficiency and short-term investing behaviour. That theme has been taken up broadly in the investment industry too – Larry Fink, CEO of Blackrock, in a letter[3] sent to the Chairmen and CEOs of the top 500 US companies in 2015 noted that: "more and more corporate leaders have responded with actions that can deliver immediate returns to shareholders, such as buybacks or dividend increases, while underinvesting in innovation, skilled workforces or essential capital expenditures necessary to sustain long-term growth".

In his paper, *The Why Question*[4], Saker Nusseibeh, CEO of Hermes Investment Management, looks at how economics has developed as a science, which is now "severely dated, 'and the functioning of the global capital markets has become separated from the real world".

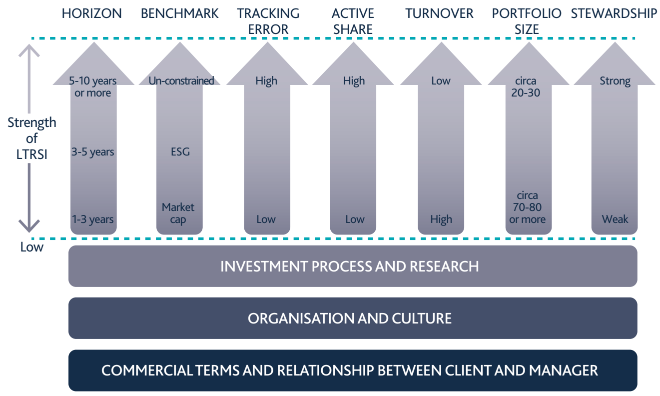
The recent collection of papers, 'Perspectives on the Long Term' from the Focusing Capital on the Long Term group, brings together the views not just of those two constituents, but also includes, asset owner organisations, corporates themselves, and other capital market observers and participants. So if everyone is broadly in agreement, what is the obstacle to greater take up of genuine long-term investing?

Communication is vital and asset managers need to be clear with asset owners that the relationship between the number of stocks in the portfolio and their ability to conduct comprehensive fundamental research as well as achieve the objectives of long-term investing.

CHARACTERISTICS

Let us begin by defining some common characteristics that define long-term investing. The Investment Leaders Group at the University of Cambridge's Institute for Sustainability Leadership provides an elegant framework:

Figure 1: Building blocks of long-term, responsible and sustainable investment:



Source: University of Cambridge, Hermes IM

[2] The Kay Review of UK Equity Markets and Long-Term Decision Making, Final Report, (2012), available at: http://www.bis.gov.uk/assets/biscore/business-law/docs/k/12-917-kay-review-of-equity-markets-final-report.pdf

[3] Full letter published in Business Insider at http://uk.businessinsider.com/blackrock-ceo-larry-fink-letter-to-sp-500-ceos-2016-6

[4] S. Nusseibeh, 06 March 2017, "The Why Question" https://www.the300club.org/wp-content/uploads/2017/03/300-Club-COMMENTARY-0217-The-why-question-Saker-Nusseibeh-FINAL-060317.pdf

Overview of characteristics

- Forging closer ties with common investment beliefs
- Risk
- Benchmarking
- Unlocking value through engagement and active ownership
- Turnover
- Portfolio Construction and Holdings
- Investment process
- Organisational culture
- Commercial model

Forging closer ties with common investment beliefs

A crucial component and foundation for successful implementation is to better align the interests of asset owners and managers. Asset owners, in fact, can set the tone and be leaders in developing balanced, long-term capitalism that ultimately benefits everyone. For example, instead of selling a company that is floundering or being taken to task for poor environmental, social, or governance (ESG) practices, they can work together with asset managers to create value, engage with a company and build upon that corporate relationship over the long haul.

In order to stay on the same page, both asset owner and manager should formulate investment beliefs that offer a flexible but coherent and disciplined foundation that can be applied even as organisations undergo change and markets fluctuate. Working together to develop well-substantiated and articulated investment beliefs can help justify a long-term investment strategy and culture. It also enhances the trust that that boards, trustees and beneficiaries of institutional investors have in the managers' capabilities plus provides a stronger license to negotiate short-term gyrations. Companies are better able to focus on building long-term value because they know that their securities are being held, and capital supplied, by patient investors.

Working together to develop well-substantiated and articulated investment beliefs can help justify a long-term investment strategy and culture.

This means employing consistent processes and practices that look beyond short-term market turbulence and concentrate on the long-term fundamentals and drivers of a company's strategy. It is also crucial to remove the inevitable behavioural biases that creep in because they can distort rational decision making and cause conflicts of interest. In the absence of clear, strongly held convictions, investors are liable to drift from one strategy to another or run with the herd chasing the next big thing. This often results in high transaction costs and performance drag. However, developing tenets that acknowledge these difficulties can then be used to construct incentives and processes that counter them.

The Ontario Teachers' Pension Plan (OTPP), a major Canadian pension fund, offers a good illustration. It formulated its investment beliefs at a one-day offsite with 100 of its senior investment professionals. The ensuing 12 guiding principles[5] were encapsulated in a poster that was signed by all staff and framed copies were prominently displayed on each investment floor and in OTPP's global offices. There was buy-in to these beliefs from all quarters of the organisation and they served as a touchstone for the evaluation of new and existing investments and processes.

Beliefs will incorporate a view on an appropriate investment horizon, which to a large extent will be determined by a discretion over trading and the information used to arrive at investment decisions. Ideally a long-term investor will commit their capital such that they do not find themselves in the position of being forced to trade, even by virtue of their funding or liability requirements. Likewise their information set will be focused on longer-term future outcomes (ie cash flows and their use) rather than near-term opportunities (often based around price). Add to this a positive view of the potential impact for stewardship, a topic to which we will return later in the paper.

[5] OTPP's investment beliefs: https://www.otpp.com/investments/performance/investment-strategy/our-beliefs

Risk

Hand in hand with developing investment guidelines is a renewed focus on risks. The academic literature informs us that risk and return have their own term structures, and that it is entirely feasible to have different portfolios that are optimal over different horizons. Like short-term investing, long-term investing has its own set of issues and investors have to be aware as well as able to manage the uncertainties that will occur. This not only involves looking at the key risks but also the risk appetite and measures that need to be adopted. One way, recommended by the FCLT paper, is to construct a risk appetite statement (RAS) which sets the overall tone, capacity and tolerance for investment-related risks that are taken in pursuit of strategic objectives.

A comprehensive long-term oriented RAS should include the organisation's motivation for accepting, mitigating or avoiding certain types of risks (including ESG risks). It should also identify constraints such as liability requirements, specify measures such as the likelihood and magnitude of tail losses and set out monitoring mechanisms. Last but not least, it is important to acknowledge there will be periods of short-term volatility and to pinpoint the economic and market conditions in which they will arise.

Asset owners and managers embarking on the path of long-term investing will need to invest some time to agree the appropriate lenses through which to measure risk.

Risks, of course, will vary depending on the organisation and their particular requirements and strategies. This is why a primary concept or philosophy should be adopted for measuring and communicating risk throughout the different levels of the organisation. However, there is no single metric that can fully capture risk which is why investors will need to apply a range of metrics linked to different time horizons. Equally as valuable is the establishment of minimum acceptable risk levels and acceptable expected returns. This is because too little risk can cause an organisation to miss its performance targets and fall short of meeting its liabilities or other strategic objectives.

To be more relevant to long-term investing, one major national pension reserve fund analysed different key criteria for its primary risk metric. It chose the potential loss over a multi-year horizon in order to be forward-looking, rather than relying solely on historical data and reported "fair values" for private assets. It also incorporated both the likelihood and magnitude of tail losses.

$116.5BN

Washington State Investment Board devised a set of risk appetite statements:

1. **Managing assets – investment and fiduciary**
2. **Managing the organisation – operational, strategic, governmental/environmental;**
3. **Reputational risk**

The $116.5bn Washington State Investment Board is also held as a good example of a pension fund that has constructed a sound risk management framework for long-term investing. It devised a set of risk appetite statements for each risk it managed and categorised them in three groups: (i) managing assets – investment and fiduciary; (ii) managing the organisation –operational, strategic, governmental/ environmental; and, (iii) reputational risk. This not only helped the fund clarify its business resources and structures but also documented its appetite for each key risk over the appropriate timeframe.

The Environmental Agency Pension Fund has also implemented stringent risk controls that focus on absolute measures against cash or liabilities instead of relative measures that use a benchmark. The fund also has proxies for long-term ESG risks such as carbon exposure and governance quality. As a result, portfolios are relatively concentrated and they avoid active mandates where stocks are only held to reduce risk against a benchmark.

All in all, asset owners and managers embarking on the path of long-term investing will need to invest some time to agree the appropriate lenses through which to measure risk. Downside risk will likely feature far more in their thinking than it would for short-term investors mostly concerned about risk relative to some index benchmark, and they will need to guard against the notion that short-term investing is likely to be perceived as potentially more informed and reliable because the long-term appears more distant and uncertain by definition.

[6] https://www.hermes-investment.com/ukw/wp-content/uploads/sites/80/2017/08/Hermes-EOS-Stewardship-Brochure-August-2017.pdf
[7] Clark, Gordon L., A. Feiner, & M. Viehs (2015). 'From the Stockholder to the Stakeholder – How Sustainability Can Drive Financial Outperformance'. *Research Paper, University of Oxford.*
[8] Hoepner, Andreas, I. Oikonomou, Z. Sautner, Laura T. Starks, & X. Zhou (2016). 'ESG Shareholder Engagement and Downside Risk'. *Working Paper: University of Reading.*

Benchmarking

Measuring the success of investment strategies over the long-term can be difficult as there is often a dichotomy between asset owners and managers. The former may use liability-related benchmarks to assess their own overall success and then impose a conventional index measure on the latter before the fund manager even goes to the portfolio drawing board.

When it comes to the selection of benchmarks, institutional investors need to review their current stable to see whether they hinder or reinforce long-term investing and, if any adjustments, additions or replacements are required. Market capitalisation-weighted benchmarks mirror the average return, while fundamentally weighted tend to fully reflect long-term sustainability risk and opportunity. Asset owners with solid investment beliefs on sustainability, and sufficiently strong in-house resources, can use adjusted or tilted indices to mitigate systemic risk and capture company-specific opportunities. Alternatively, specifically designed indices such as S&P's Long-Term Value Creation Global Index may fit the bill.

Step one is to analyse whether the benchmark manifests and measures the asset owner's intended investment strategy. Ideally, these strategy benchmarks should encourage asset managers to think like business owners by assembling a portfolio of superior, long-term-oriented companies rather than focusing on quarterly returns. They do not need to be an investable index or be used for rating manager-performance but instead can specify a metric such as absolute return or rate of real value creation that matches the mandate horizon, opportunities, risks and costs.

Examples include a multi-year absolute return target, such as inflation + X% as well as a blended index that conveys the long-term exposure and risk expectations of the strategy. Caisse de Dépôt et Placement du Québec's Global Quality Equity (GQE) portfolio is measured (not managed) against 85 percent MSCI ACWI unhedged plus 15 percent DEX 91-day treasury bills. The portfolio holds established companies with proven business models plus has exposure to global growth and stable earnings over the long-term.

Caisse de Dépôt et Placement du Québec's Global Quality Equity portfolio is measured against:

85% + **15%**

MSCI ACWI unhedged | DEX 91-day treasury bills

As for an execution benchmark, it should reflect expected portfolio construction and characteristics and be used to judge an asset manager's execution acumen against the agreed mandate over time. There has been a lot of work done in this area over the past few years with the development of non- market capitalisation or alternative indexation and there also continues to be a plethora of new entrants including Norway's Norges Bank Investment Management which has proposed a generic modelling framework that weights companies by sector characteristics, manager skill, risk appetite and market conditions.

Although there has been progress, more work is still needed to create benchmarks that foster a longer-term orientation. Wider adoption by asset owners and managers could help exert greater influence on boards and management companies to employ strategies aimed at long-term growth and cash flow generation rather than short-term impact on stock price. All sides can help to promote collaboration needed between index providers, asset owners and asset managers.

[9] Dimson, Elroy, O. Karakas, and X. Li (2015). 'Active Ownership'. *The Review of Financial Studies*, 28(12), 3225-3268.
[10] Barko, T., M. Cremers, & L. Renneboog (2017). 'Activism on Corporate Social Responsibility'. *ECGI Working Paper*

Unlocking value through engagement and active ownership

Integrating ESG criteria into the investment decision making process is not a new trend but one that is gaining momentum. One reason is that it enables managers to mitigate ESG risks as well as identify those companies exploiting the benefits. For example, BP's Deepwater Horizon and more recently the Volkswagen emissions debacle have cost investors significant sums but there is also a growing body of academic research that shows correlations between better company ESG performance and higher-quality management, stronger growth and lower cost of capital as well as superior, risk-adjusted performance over the long-term. Our stewardship and engagement team, Hermes EOS, aims to protect the value of our clients' assets by engaging in the long-term risks that affect the long-term growth and profitability of the companies they own[6].

This is highlighted in a meta-study from the University of Oxford – *From the Stockholder to the Stakeholder: How Sustainability Can Drive Financial Outperformance*[7] – which assessed over 200 academic studies. It revealed that 88 percent of the research analysed showed solid ESG practices led to better operational performance of companies while 80 percent found stock price performance was positively influenced by good sustainability practices.

Moreover, a study by sixteen UK pension funds, including the BT Pensions Scheme, The Pensions Trust and RPMI Railpen, representing over £200bn of assets – *A Guide to Responsible Investment Reporting in Public Equity* – noted that responsible investment reporting helps to improve both the transparency and accountability between asset owners and fund managers.

Assessment of over 200 academic studies reveals:

88%

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80%

found stock price performance was positively influenced by good sustainability practices.

The exercise of corporate stewardship must lie at the heart of any long-term investment programme.

However, to make a real difference, asset owners and managers have to move beyond the conventional exclusion process that eliminates companies engaged in activities such as weapons, tobacco, alcohol or cluster bombs. Positive inclusion is unlikely to be sufficient for the true long-term investor either. A more meaningful method would be one that incorporates ESG as non-financial criteria alongside cash flows and P/E ratios, as well as active shareholder engagement that encourages companies to mitigate prominent ESG risks relevant to their sectors. For example, research on the engagement data[8] from Hermes EOS shows that companies which are exposed to shareholder engagement from Hermes EOS generally have lower downside risk, especially when they show a positive attitude towards changing their environmental, social, and governance (ESG) practices. Dutch pension funds have been at the forefront with PGGM/PFZW often cited as model examples of long-term sustainable investors. The separation of investment strategy and administration between PFZW and PGGM, its pensions and investment management services providers, triggered a rethink of its investment strategy with major input from the board of directors. The resulting investment framework retained an exclusion policy but developed the ESG concept much further by investing in companies that generated returns for the portfolio but also created social added value.

They also strengthened the exercising of voting rights and actively confronting companies about their policies and activities. For example, they would first try and engage with companies who were breaching human rights of environmental laws before taking them off their investment roster. However, they would be willing to take companies in and outside of the Netherlands to court to recover investment losses or enforce good corporate governance.

The exercise of corporate stewardship must lie at the heart of any long-term investment programme[9] – it represents a willingness to engage with firm management to seek change that will benefit shareholders over a long horizon. Engagement is no quick fix, of course, and only those shareholders that stay the course will usually get to enjoy the full benefits of the active engagement[10].

Turnover

Asset owners should not underestimate the impact of turnover on their equity managers' portfolios, as it can both hide costs, and acts as a reasonable proxy for the short- or long-term behaviour of managers, according to the 2° Investing Initiative and the Generation Foundation, a multi-year partnership formed to explore and address the "Tragedy of the Horizon."

Their latest report – *The long and winding road* – focused on the role turnover plays in the asset owner-asset manager relationship. The group, which analysed over 3500 institutional long-only active equity funds in consultancy Mercer's global investment database, found that these fund managers replaced all of the names in their portfolio every two years, on average. This equates to a share replacement rate of 1.7 years. While this is an improvement since the financial crisis, Mercer's review of academic literature suggests that the current average turnover is still twice as high as the hypothetical optimal from a risk return perspective.

3500

Institutional long-only active equity funds analysed found fund managers replaced all of the names in their portfolio every two years.

The paper noted that the worst offenders were those employing quantitative strategies. On average, they exhibited higher turnover than fundamental and blended strategies; and there were cases where managers made suboptimal decisions due to their belief that clients could not tolerate short-term volatility. Latency sensitive or high frequency strategies clearly influence the picture, but there is little doubt that long-term managers make themselves evident through their average holding periods and turnover ratios.

Although there is not an ideal timeframe, the academic research gathered by Mercer indicated that a four-year holding period (25 percent turnover) is ideal, well below the current 58% average turnover rate identified in its analysis. The paper set out recommendations for asset owners to improve the way they monitor and communicate with asset managers in order to encourage optimal behaviour. This includes attaching a so-called behavioural policy statement to their investment beliefs that explicitly outlines their time horizons and expectations for their asset-class exposures and the types of investment managers and strategies they will employ. The design of employee compensation and incentives, and expectations for how they will interact with clients should also be a main part of the discussions.

Asset owners are advised to monitor asset managers against expectations in turnover as well as portfolio characteristics and drivers of activity. The actual returns versus the hypothetical buy-and-hold performance of the portfolio should also be compared over a given period, to assess the benefit of portfolio turnover.

Portfolio Construction and Holdings

There is no theoretically 'correct' size for a genuinely long-term portfolio, but it seems plausible that smaller portfolios enable deeper fundamental research and engagement, which in turn incentivises companies to adopt a longer horizon and more sustainable business practices especially when this is combined with committed stewardship. By contrast, a larger number of holdings make it difficult to conduct such comprehensive and detailed research, and render meaningful engagement nigh on impossible, without incurring unacceptable costs.

Some advocate holdings of less than 75 stocks as being ideal which is lower than many conventional equity portfolios. In some cases it can be as few as 20 to 30. This is the case statistically with absolute return-focused strategies which require only about 25–30 stocks with an average degree of non-correlation to diversify most of the non-systematic risk in a portfolio. Communication is always critical and asset managers should explain to asset owners the relationship between the number of stocks in the portfolio and their ability to conduct adequate fundamental research as well as achieve the objectives of long-term investing.

As for construction, this will vary according to institutional investors' requirements and restrictions although there are common themes. Geoff Warren, research director at Australia's Centre for International Finance and Regulation, contends that while short-term investors are inclined to look at anything that might move share prices in the near term such as a surprise in quarterly earnings, streaming 24 hour news or unexpected events, their long-term peers will be more concerned with a company's capacity, for example, to generate healthy cash flows and its reinvestment decisions. The price paid for these streams will also be of interest as this truly determines the return expected over the long-term.

Communication is always critical and asset managers should explain to asset owners the relationship between the number of stocks in the portfolio and their ability to conduct adequate fundamental research.

Investment process

Pulling together these different tools and strategies requires a different mind-set and framework than the mainstream short-term mandates that have dominated the investment world for the past several decades. Research from Willis Tower Watson's Thinking Ahead Institute (TAI) recommends dividing the investment process into four separate elements in order to better clarify the process needed for a long-term view.

The first category – mandates/portfolio guidelines – comprises a long-only mandate of diversified public equities where there is flexibility to return capital and raise cash but constrains engaging in leverage. The TAI set the overarching return goal at CPI plus 5% per annum over a seven year rolling period with a secondary target of 2% per annum above a composite of global equity indices over the same timeframe. This mix of objectives over a sensible number of years offers an interesting comment with respect to multi-benchmarking.

The second group – compensation – is always a tricky subject and one that is open to discussion. The TAI proposes a fixed monetary fee indexed to CPI and while it is not a proponent of performance fees, it would place a cap of no more than 10% carry on one if based upon a straight linear share of the value which would be determined relative to a balanced scorecard. The fee would also be divided into a vesting portion determined over a rolling seven year period with a high watermark and a non-vesting portion paid after seven years.

Measurement

7 year

rolling period with more frequent reviews in the early years of the mandate and less as it matures.

It could be that renewed interest in and take-up of these strategies will help propel the market to a longer-term stance for more traditional, public market assets, and a tolerance for reduced liquidity that is a prerequisite of long-term investing.

As for measurement, the TAI believes metrics should be agreed upon between asset owner and manager with the executive and investment committees responsible for monitoring. Again a seven year rolling period would be the preferred time horizon although there would be more frequent reviews in the early years of the mandate and less as it matures. A balanced scorecard would be applied with both absolute and relative performance being measured.

In terms of structure, both closed and open ended funds could be used although the TAI favours the former. It advocates having an executive team in charge of commercial terms, oversight and monitoring the managers while changes in personnel should be dealt with on a case by case basis.

In terms of styles, value strategies naturally rely upon longer investment horizons in the sense that they generally require some form of reversion to true fundamental value in order to pay off, but that is not to say that growth-oriented approaches cannot also be long-term in nature, particularly when they focus on shareholder wealth generation through recognition of future investment and capex opportunities.

Alternative assets naturally lend themselves to long-term investing as they entail exposure to illiquidity in terms of the length of their commitment. It could be that renewed interest in and take-up of these strategies will help propel the market to a longer-term stance for more traditional, public market assets, and a tolerance for reduced liquidity that is a prerequisite of long-term investing.

Organisational culture

Changing a culture is often compared to turning a tanker ship around but there is no doubt that long-term sustainable investing requires a new work environment, mentality and skillset. State Street and the CFA Institute's paper, '*Discovering Phi*'[11] , points to research based on Self Determination Theory which perhaps sounds esoteric but lays the foundation for a creative workplace that can help unlock the individual's potential and generate long-term value.

There are four main building blocks starting with cognitive flexibility which means the ability to adapt to disruptive forces within an organisation. Managers also need to be creative and think out of the investment box. This has become an increasingly important trait in an environment where the herd mentality still reigns and performance can quickly become compressed as investors pile into the next best thing. Ownership, where individuals feel they have an integral stake in the organisation, should not be underestimated either, nor should citizenship where they go above and beyond their job description for the sake of the health of the company.

Managers also need to be creative and think out of the investment box.

Culture too can build the glue around which alignment and trust are built, orienting a relationship naturally towards the longer-term. Professionalism, leadership, support and coaching all have a role to play, together with a supportive investment oversight environment. Organisations that seek to promote these attributes will find themselves well-suited to longer horizon investing. Governance will also play a role, allowing confidence to develop in the partners. Expectations can be properly managed by a manager as they guide an asset owner through their decision-making process, and collaboration will only serve to reinforce any trust that is built up.

Commercial model

As earlier stated compensation is always a contentious subject but the *Long Term View* paper highlights the processes that can be implemented to better align the interests of asset owners and managers. In other words, both should lose and win in parallel. If performance fees are applied, they should be simple, transparent and clearly incentivise long-termism.

Equally as important is the commercial model between clients and fund management groups in terms of incentives. Ideally, the bonuses of portfolio managers and analysts should be weighted predominantly towards the longer term, ideally five or more years. If a proportion of the bonus is paid for shorter term performance, then clawback provisions can shift the incentive and be geared towards the longer term view.

The paper also shuns basing performance related pay solely on quantitative factors. Qualitative dynamics such as contribution to teamwork, a systematic evaluation process and integration of ESG issues into investment decisions should also play a significant part. Moreover, as with the WTW research, sufficiently long vesting periods are seen as fostering long-termism as well as potentially the pursuit of absolute returns over relative returns.

Qualitative dynamics:

- Contribution to teamwork
- Systematic evaluation process
- Integration of ESG issues into investment decisions

Finally, manager co-investment will likewise align interest between the different parties involved, and given a true sense of shared gain and sometimes pain. In such situations it becomes far easier to convince an asset owner of the appropriateness of a longer-term approach where funds are locked-in for an extended period often under strict contractual terms.

[11] 'Discovering Phi: Motivation as the Hidden Variable of Performance', State Street and the CFA Institute

SUITABILITY

As this paper has reiterated, the relationship between the asset owner and manager is an essential component in the cultivation of a long-term and sustainable culture. Before selecting a fund manager, asset owners need to conduct stringent due diligence that carefully assesses people, philosophy, processes and potential partnership. While past performance should be taken into account, there needs to be a stronger recognition of the role that luck can play in generating returns over a short period. Therefore, asset owners should look behind the figures at the characteristics and context of performance as well as the portfolios and processes that the manager has built. Attention should be given to the pattern of the resulting performance to gain a better perception into their long-term strategies and systems in effective action. There are a number of qualitative and quantitative factors that asset owners can employ to judge whether asset managers are paying lip service or truly adhere to a long-term focused investing culture.

Luck may dominate in the short term, but skill is the key in the long-term

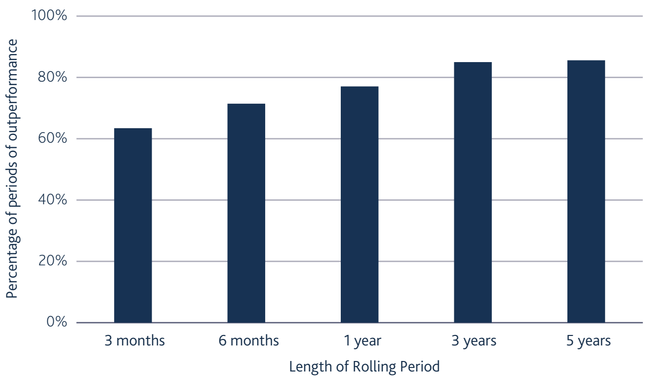
Asset manager's perspective

Although convincing asset owners to be patient can be challenging, the performance of long-term asset managers should be rewarded. We examine our own funds' track records to establish that lengthening the period of evaluation allows the noise (short-term volatility) to begin to wash out and the signal (alpha skill) to shine through, while for shorter time periods noise dominates. In other words, luck may dominate in the short term, but skill is the key in the long term – the longer the horizon, the more skill (the manager's ability to outperform) is given the chance to shine through.

Hermes' equity portfolios employ a long-term investment philosophy (whether value- or growth-oriented) and a process that involves focusing on business fundamentals and long-term franchise value.

Figure 2: Equity portfolio longevity

Hermes Equity Strategies Outperformance by Investment Horizon

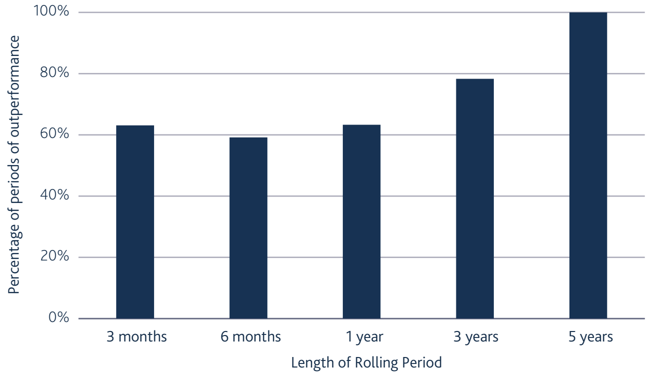


Source: Hermes IM

Our credit portfolios follow a similar path.

Figure 3: Credit portfolio longevity

Hermes Credit Strategies Probability of Outperformance by Investment Horizon



Source: Hermes IM

The purpose of using rolling periods is that they do not anchor on a specific starting date, but instead look at the likelihood that an investor sees outperformance when invested for a certain period of time using a random entry date. More importantly, it shows how the strategy tends to perform over various periods of measurement.

Relative performance of investment strategies is not far removed from a coin-toss in that short-term volatility (ex-ante tracking error) simply dominates manager skill – a manager with true long-term ability might underperform in the short-term. Not all asset managers will have a philosophy and a process, not the cultural bent, that lends itself to long-term investing.

Asset owner's perspective

In a speech last year "Extracting Sustainable Returns in a Global Context," Adrian Orr, CEO of the New Zealand Super Fund (NZSF) and Chair, International Forum of Sovereign Wealth Funds highlighted the main advantages of being a long-term investor. First was the ability to weather much of the short-term price volatility and not be forced to sell assets when the holdings were worth the least. However, that comes with the recognition that markets can suffer from bouts of extreme risk aversion or outright panic, and at the very least go through dynamic cycles.

Next was the flexibility to pursue more illiquid investment opportunities and to reap the premium. Investments are also not driven by reputational or career concerns derived from short-term return comparisons. For example, the NZSF's investments in catastrophe reinsurance and life settlements, as well as its various arbitrage strategies, have leveraged its stable risk appetite, time horizon and liquidity profile. Orr said that this has generated higher long-term returns given the inability of other, more short-term orientated investors to do the same.

Long-term investing will not be for everyone, and nor is it of necessity a panacea. However, there are some pre-conditions that we highlighted earlier that makes it more suited to certain asset owner and asset manager types. A relationship built on trust and respect between two well-aligned partners can be fruitful in the long-term for both, and also the ultimate beneficiaries.

MEASUREMENT

One of the biggest stumbling blocks is that the metrics that calculate the long-term performance and health of companies such as ten-year economic value added, research-and-development efficiency, the patent pipeline, multiyear returns on capital investments, and energy intensity of production, are generally lacking. They also do not capture the ESG outcomes that many investors are focusing on nor the intangible assets or overall long-term value.

One reason, according to EY in its paper In *Accounting and Reporting for the Long Term*, is that the format of today's annual reports and accounts has not altered dramatically since the 19th century. However, while specific measures will vary by industry and company, there are many common threads and having more granular information across a wider range of metrics would provide a better understanding a company's existing and future direction, regardless of its size or sector.

To help rectify these shortcomings, EY has built a Long Term Value (LTV) model, which is based on strategic and integrated reporting. The aim is to not only to simplify and make the process more precise but also to paint a comprehensive and holistic picture of a company's business model, strategy, development, performance, position and long-term prospects. Greater transparency and disclosure should also forge stronger bonds and increase trust among its stakeholders.

There is no doubt that long-term sustainable investing requires a new work environment, mentality and skillset…..Culture can be the glue around which alignment and trust are built, orienting a relationship naturally towards the longer-term.

The EY LTV model has three main pillars starting with context which covers the business cycle and other long-term macroeconomic, political technological, market, societal and political trends. Differences are factored into the analysis. For example, product development at an aerospace firm will take decades whereas six months is a perfectly adequate time for a start-up. The second section focuses on an organisation's reason for being. It identifies which stakeholder groups are critical to its purpose and well-being but the onus is also on the company to prove it is fulfilling its purpose and creating value across the board.

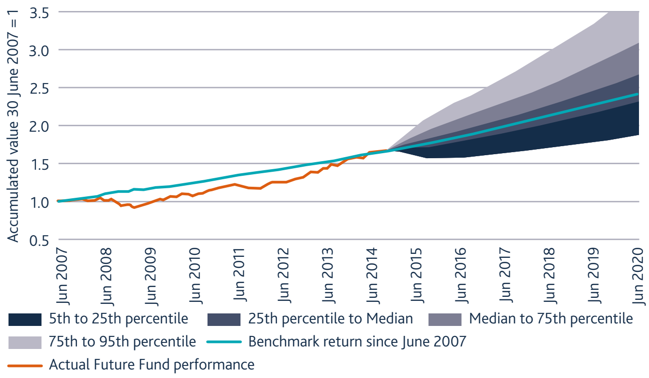
The final section revolves around stakeholder value analysis, which constitutes the bulk of the LTV report. It comprises a series of one page reports for individual stakeholders with the intent of measuring the outcomes to see if the company is delivering the promised goods and creating long-term value.

Australia's Future Fund has chosen to use a three year period for total portfolio performance and an annual assessment against role-specific objectives – this may not quite align with truly long-term objectives, but certainly seems a significant step in the right direction. There are a number of suggestions for appropriate performance measurement in the literature, from simply de-emphasising relative performance through to more sophisticated combined absolute return outcomes touched upon earlier.

Whatever the window, it is clear the performance should be seen in terms of progress towards an ultimate goal. Indeed, the Future Fund follows just such a model and seeks to estimate the likelihood of achieving a specified goal given current circumstances and what has happened to date.

Figure 4: Progression towards Long-term Objectives:

Fan chart of the actual and forecast accumulated Future Fund return compared to the benchmark return (CPI + 4.5% pa)

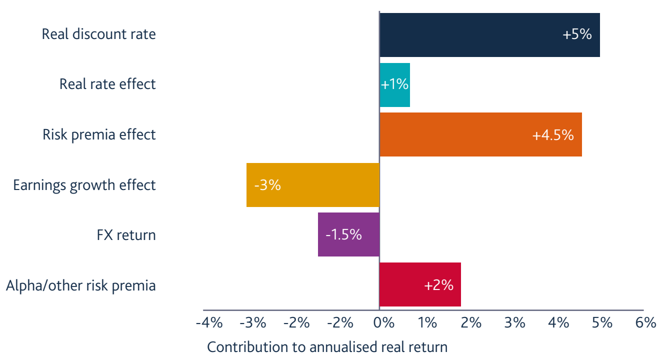


Source: Future Fund of Australia

Similarly, performance attribution should aim to breakdown outcomes into those components that are important to the achievement of longer-term objectives. Those would include changes in expected cash flows, changes in the discount rate, and the long-term expected return. Again, the Future Fund has an interesting take on this issue:

Figure 5: Return Attribution

Attribution of total Future Fund annualised real return from 1 July 2009 to 30 April 2014



Source: Future Fund of Australia

This methodology is forward-looking and relevant to the long-term by design. It provides clarity with respect to the original investment strategy and it focuses on the key elements that will determine attainment.

CONCLUSION

Although the asset management industry has made some strides, there is still much work to be done in promoting and adopting a long-term investment horizon. In fact, almost ten years after the sub-prime mortgage crisis that triggered a global financial crash, analysts are still largely ignoring long-term financial risks, such as those emanating from climate change, the energy transition and disruptive low carbon technologies, according to *All Swans are Black and Dark*, the first report from the 2° Investing Initiative and the Generation Foundation.

As this report notes, there are a host of reasons behind this, ranging from a shortage of data from companies to the high cost and low benefit of long-term analysis, the dearth of a standardised framework for long-term risk analysis and lack of demand from investors. Equally as relevant are the short-term pressures of compensation, incentives and the seemingly all-consuming focus on the latest share price as well as quarterly earnings reports. This can lead to the mispricing of long-term risks, culminating in a mismatch between the asset owners' liabilities and assets.

While all stakeholders have their part to play in reshaping the industry, asset managers should be encouraged to better align their interests with asset owners and move to balanced, long-term capitalism that ultimately benefits investors as well as society. While their boards need to have the requisite skillset and understanding of the issues, there are also today the mechanisms, measurement tools, frameworks and processes that can be implemented to reduce short-term pressures and promote long-term countercyclical performance.

Long-term investing may not be the holy grail – it involves sometimes difficult costs and trade-offs that should be well understood, and it also leads to the assumption of different risks. In short, it will not be for everyone. However, for those that are up to the challenge, the task is to identify an overall package of conditions that best suit the end investor, and offer the investment manager the greatest prospect of success. This paper has attempted to put forward a broad range of concrete suggestions, which are in essence a self-reinforcing menu of options, but there is no single palliative.

Asset managers should be encouraged to better align their interests with asset owners and move to balanced, long-term capitalism that ultimately benefits investors as well as society.

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