Investing for the future

How institutional investors can reorient their portfolio strategies and investment management to focus capital on the long term

March 2015

Focusing Capital on the Long Term (FCLT) is an initiative for advancing practical actions to focus business and markets on the long term. It was founded by the Canada Pension Plan Investment Board and McKinsey & Company. More information can be found at fclt.org.
Introduction

Understanding the important role that institutional investors play in the investment value chain, the Focusing Capital on the Long Term initiative gathered more than 20 experienced investment professionals from nine institutional-investment organizations controlling an aggregate of over $6 trillion in assets under management. Our goal was to develop practical ideas for how institutional investors might reorient their portfolio strategies and management practices to emphasize long-term value creation and, by doing so, be a powerful force promoting a long-term mind-set throughout the investment value chain.

The result of our work provides recommendations across five core action areas that all institutional investors must consider: investment beliefs, risk appetite statement, benchmarking process, evaluations and incentives, and investment mandates. We believe these five areas collectively provide a framework for institutional investors to improve long-term outcomes for their portfolios, their investee companies, and ultimately for all stakeholders.

This paper is written by investors, for investors. A diverse group of institutional investors and investment professionals helped contribute to this paper and each may hold the ideas expressed to varying degrees. Within the context of their own unique situations, we encourage institutional investors to evaluate, adapt, and adopt an organizationally appropriate mix of the following ideas to enhance the long-term value they create for their beneficiaries.

### Five core action areas for institutional investors

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### Institutional investors should...

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INVESTING FOR THE FUTURE

Guiding principles

Understand and define the characteristics of long-term investing. Develop a set of principles that can guide, and be used to test, current or future practices.

Asset owners and managers should have a mutual understanding of the characteristics of long-term investing and a set of guiding principles in order to create the necessary foundation to ensure the five core action areas are considered from an aligned perspective focused on long-term value creation. Such a foundation can help ensure a long-term-focused culture pervades each of their organizations.

Long-term investing...

- is a frame of mind rather than a holding period, and a culture rather than a directive
- is about making investment decisions with a sustainable future-oriented perspective
- takes advantage of opportunities created and/or unable to be taken by short-term investors
- emphasizes process and fundamental long-horizon corporate research rather than focusing solely on quantitative data analyses
- requires persistence through periods of short-term underperformance and reaps the rewards of patience
- is not a continuing sequence of short-term investments nor simply about buying and holding assets
- is not driven by rankings and benchmarks (it is not a “beauty contest”) but focuses on long-term expectations and outcomes
- is consistent with the time horizons and ultimate needs of most savers by providing asset owners with the ability to meet liabilities today and for many years into the future

Long-term investors are stewards of capital who have the ability and willingness to invest in businesses to create and grow value on a sustainable basis for their stakeholders.4

To align their organizations, people, and partners to the long term, asset owners and managers should consider developing a set of principles that they can use to assess their current practices and to guide their creation of truly long-term strategies moving forward.

Guiding principles for investors to consider

1. Align stakeholders and minimize agency costs
   - Discuss and agree on a core set of investment beliefs that translate readily into actions.
   - Clarify risk and risk appetite and define appropriate long-term metrics.
   - Set structures, terms, and expectations in asset managers’ mandates to align fully with the strategy and objectives of the asset owner.
   - Agree on success measures to foster and evaluate long-term value creation.

2. Focus on intrinsic value of assets and long-term real value creation
   - Invest rather than speculate—build and manage the portfolio as business owners who invest capital where it will grow rather than unduly focusing on a benchmark.
   - Assess a company’s fundamentals and ability to generate long-term real value based on the relative lifetime of the underlying business assets.
• Use current market pricing primarily to determine margin of safety versus the intrinsic value of the underlying business and thus the timing and sizing of investment.
• Give appropriate weight to inherently long-term factors, including the long-term implications of environmental, social, and governance (ESG) risks and opportunities.

3. Develop and execute robust, sustainable investment processes
• Allow and encourage portfolio management to remain focused, patient, and disciplined.
• Create and use the ability to be countercyclical.
• Stay the course in market cycles and turbulence, yet adapt to secular evolution.
• Help build trust and partnership between asset owners and asset managers.

4. Positively influence the management of investee companies
• Fulfill shareholder responsibilities to be engaged owners of both active and passive long-term holdings.
• Engage in constructive two-way dialogues with companies.
• Focus on corporate strategy, key longer-term performance indicators, and activities that will enhance the intrinsic value of the business.
• Be prepared to support companies facing short-term threats if they present sound plans and processes for long-term value creation.

1 Investment beliefs

Clearly articulate investment beliefs, with a focus on their portfolio consequences, to provide a foundation for a sustained long-term investment strategy.

Investment beliefs are tenets and principles based both on conviction and fact. They can help set the investment philosophy, provide a long-term compass to select investment strategies, and help navigate short-term turbulence. Institutional investors should explicitly state their investment beliefs and summarize the rationale for these beliefs. By definition, beliefs cannot always be substantiated with unequivocal evidence. Rather, investment beliefs are collective judgments based on academic literature, research, and experience. Whether or not they are formally adopted or even stated, these beliefs form the foundation of all investment strategies and decisions. In the absence of clear, strongly held convictions, investors are liable to lose money by drifting from one strategy to the next.

To articulate, or rearticulate, investment beliefs to reflect long-term orientation and intentions, institutional investors should:
• Involve and ensure the commitment of all major internal stakeholders (that is, the board, senior leadership, and all levels of the portfolio-management team) in the formulation process to develop a set of investment beliefs that will be universally adhered to by employees, management, and the board.
• Examine and record why they hold particular beliefs and analyze their practical implications.
• Determine if their beliefs provide a valuable long-term compass to guide their selection of investment strategies and to navigate short-term turbulence.
• Consistently check to ensure investment beliefs are reflected in the investment process.

Each institution should identify a set of beliefs that is most pertinent to their investment purpose and method.
A selection of investment beliefs that a long-term investor may wish to adapt and adopt include the following:

1. Long-term investors should focus on the fundamental drivers that affect the underlying value of a business.
2. Market prices deviate significantly from fundamental or intrinsic value in the short run.
4. Long-term investment strategies must be more concerned with long-term risk of loss than short-term volatility.
5. Diversification is essential, but only if it is applied across truly diverse long-term fundamental factors.
6. Long-term investors can benefit from their ability to buy and sell at any time without compulsion, and can reap the rewards of long-term outcomes whose short-term path is uncertain.
7. Long-term partnering relationships (between owners and managers and between investors and investees) foster better and more sustained returns.

Idea in action:
Establishing and understanding investment beliefs

Investment beliefs offsite

As Ontario Teachers’ Pension Plan (OTPP), a major Canadian pension fund, grew from a handful of investment professionals to several hundred, management decided it was prudent and useful to codify its collective investment beliefs. A few months of smaller meetings, discussions, and prereading culminated in a one-day offsite that gathered about 100 senior investment professionals to explore the organization’s fundamental beliefs. The level of management commitment signaled that the exercise was a key part of establishing OTPP’s investing culture.

Following the offsite, the final set of beliefs was shared with all staff; senior managers organized a signing ceremony where all staff signed a poster of OTPP’s newly defined investment beliefs. Today, framed copies of the poster are prominently displayed on each investment floor and in OTPP’s international offices. Staff regularly refer back to these investment beliefs when evaluating new and existing investments and processes.

Using investment beliefs to inform investment strategy

The New Zealand Superannuation Fund, a New Zealand government entity established to prefund future pension liabilities, developed an investment strategy, “strategic tilting,” predicated on two investment beliefs: First, asset classes’ returns are partly predictable. Over time, returns tend to revert toward a mean. Second, investors with a long-term horizon can outperform more short-term-focused investors over the long run.
Risk appetite statement

Develop a comprehensive statement of key risks, risk appetite, and risk measures, appropriate to the organization and oriented to the long term.

Long-term investors must be able to define, accept, and manage the uncertainty and risks associated with long-term investing. Prudent management requires investors to assess both their need and tolerance for risk. Developing a risk appetite statement (RAS) provides a mechanism to articulate the overall tone, capacity, and tolerance for investment-related risks taken in pursuit of strategic objectives.

An institutional investor’s RAS goes hand in hand with its investment beliefs. Investment beliefs guide the investment strategy. The investor’s RAS addresses the material risks in executing the strategy.

There are three essential components of a comprehensive long-term-oriented RAS:

1. Articulate the organization’s motivation for accepting, mitigating, or avoiding certain types of risks.
2. Identify constraints (for example, liability requirements), specify measures (for example, likelihood and magnitude of tail losses), and set out monitoring mechanisms.
3. Support long-term investment horizon, by acknowledging that there will be periods of short-term losses in the pursuit of long-term strategic objectives and by identifying the economic and market environments in which these losses may occur.

To influence organizational behavior in practice, the RAS should be broadly communicated, with buy-in throughout the organization. In addition, it should:

- Be specific and action oriented.
- Have a meaningful impact on the execution of the investment strategy.
- Be reviewed when conditions change materially in the context of:
  - changes in the external environment
  - effectiveness of risk management
  - loss experience, and
  - evolving regulatory or governance issues
- Be a high-level document that does not necessarily specify acceptable risk levels numerically but provides relevant long- and short-term quantitative measures of risk (that is, going beyond volatility, which does not directly capture the notion of economic loss).
- Define a primary concept/philosophy for measuring and communicating risk that can be used at different levels of the organization.

Idea in action: Defining and communicating risk

Because risk takes many forms and comes from many sources, it can be helpful to define a primary philosophy for measuring and communicating risk that can be used at different levels of the organization. For example, during its investment decision-making process, a major sovereign-wealth fund defines risk primarily as the likelihood and magnitude of “permanent impairment of capital.”

Investors commonly use short-term volatility as shorthand for risk, despite the fact that real risk entails economic loss, especially in the context of longer time horizons.

To be more relevant to the long term, a major national pension reserve fund proposed the following criteria for its primary risk metric: (i) potential loss over multiyear horizon; (ii) forward-looking, rather than based solely on historical data; (iii) recognize reported “fair values” for private assets; (iv) capture all material risks, not just systematic risks; and, (v) incorporate both the likelihood and magnitude of tail losses.
Risk is multidimensional, and capital markets are complex. Although investors may choose a primary concept for risk, no single metric can fully capture risk. Investors thus need to apply a range of metrics linked to different time horizons, including an examination of stress scenarios related to adverse future economic and market conditions. Just as important, investors also need to establish minimum acceptable risk levels and associated minimum acceptable expected returns, because too little risk can cause an organization to earn insufficient returns and fall short of its strategic objectives.

### Benchmarking process

Select and construct benchmarks focused on long-term value creation, distinguish between assessing the strategy itself and evaluating the asset managers’ execution of it.

Investors commonly use benchmarks to measure the success of their strategies. However, all too often asset owners choose a conventional index benchmark before basic portfolio-design decisions have been made. To guide how a portfolio seeks to achieve long-term value creation, clear and comprehensive articulation of the investment strategy should always come first. Only then should appropriate benchmarking be specified to measure future success.

The investment strategy and benchmarking process should entail three consecutive steps:

1. **Asset owner determines investment strategy and overall investable universe**
2. **Asset manager decides how the portfolio will achieve long-term value creation**
3. **Asset owner determines the benchmarking process to gauge future results**

In principle, security-selection decisions should be determined by the asset manager’s view of each company’s fundamentals and prospects, and then on an assessment of its intrinsic value relative to its market price. In practice, benchmarks have tended to exert outsized influence on investing choices. Too frequently, the best long-term thinking of asset managers is compromised by considerations of performance rankings, or “tracking error” against a benchmark, which may itself be ill suited.

Given the importance of benchmarking to the total investment process, asset owners should review whether their current benchmarks hinder or reinforce long-term investing and, where appropriate, supplement or replace standard benchmarks with other constructs that better support value creation over the long term.

**Institutional investors should determine which benchmarks to employ at two distinct levels:**

1. The **strategy** level, where the benchmark signals the asset owner’s intended investment strategy and is used to measure the success of the strategy itself; and
2. The **execution** level, where the benchmark reflects expected portfolio construction and characteristics and is used to assess how well the asset manager executes against the agreed mandate over time.

**Strategy benchmarks**

Once the asset owner and manager have defined an investment strategy and universe, the strategy benchmark should (1) convey the expected risk/return profile of the chosen strategy, and (2) be the measure used to determine the strategy’s success over the long term. This benchmark can serve as the main communication tool for contributors, beneficiaries, clients, the media, and the general public. The strategy benchmark need
not be an investable index. Nor does it need to be used for manager-performance rating. It may well be more appropriate for the strategy benchmark to specify a metric such as absolute return or rate of real value creation that matches the mandate horizon, opportunities, risks, and costs.

**Existing strategic benchmarks include the following:**

- a multiyear absolute return target, for example, inflation + X percent
- a blended index that conveys the long-term exposure and risk expectations of the strategy. For example, 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 strategy of this portfolio is focused on established companies with proven business models, exposure to global growth, and stable earnings over the long term. The construction and management of the GQE portfolio is therefore benchmark agnostic.
- the opportunity cost of investing in the strategy, such as an all-country or regional equity index that represents the funding source for securities selected in the portfolio

**Execution benchmarks**

Execution benchmarks typically represent a low-cost means of implementing the intended strategy. For active management, they serve as reference baselines for assessing value added by the asset manager’s execution against the mandate, and for determining related performance-based fees or incentive compensation (taking into account performance hurdles, high-water marks, and other features).

**Existing execution benchmarks that may be suitable for long-term equity portfolios include the following:**

- fundamentals-based indexes, for example, Russell or RAFI Fundamental indexes
- “quality” indexes, for example MSCI or S&P products carrying this label
- non-market-capitalization-weighted indexes; for example, Norway’s Norges Bank Investment Management has proposed a generic modeling framework that does not weight member companies by market capitalization. Instead the framework takes sector characteristics, manager skill, risk appetite, and market states into consideration.

If the mandate is clear, if the true evaluation horizon is sufficiently long (at least five years), and if the asset owner and manager are sufficiently aligned, they may agree that a distinct execution benchmark is not necessary and the strategy benchmark can serve both purposes. Then, by having the fortitude to accept likely deviations and stay the course, asset owners can encourage asset managers to focus on producing long-term returns that best achieve strategic objectives for clients and beneficiaries at the appropriate risk level.

The reality is that many asset owners will continue to employ distinct execution benchmarks, if only to clearly define the investable universe and quantify the asset manager’s skill-based value added. Traditionally, asset owners have used capitalization-weighted indexes as benchmarks. Yet if one accepts the premise that market pricing of stocks has a strong tendency to overshoot intrinsic value in either direction, then a market-capitalization benchmark by definition leads to the creation of portfolios with excessive exposure to companies that may be overvalued or simply larger.

While some currently available indexes focus on ESG factors, most do not sufficiently incorporate broader long-term value-creation factors (for example, five-year rolling return on invested capital, return on equity, and so on) that are critical to the asset owner. Asset owners must then decide whether to build a customized new index or wait for such indexes to become commercially available. Asset owners who choose the latter course can use the following criteria to select from several newer, nontraditional benchmark indexes that are not based solely on market capitalization:

- Choose more concentrated indexes, provided they retain sufficient company diversity and appropriate balance to prevent dominance by single factors.
- Place emphasis on quality, sustained profitability and/or other similar factors believed to represent longer-term characteristics of companies, in both selecting and weighting constituents.

Compared with traditional benchmarks, these indexes may often be better fits for long-term mandates.
Idea in action: Abandoning traditional market-cap weighting

The JPX-Nikkei 400 launched in November 2013. Japan Exchange Group, Tokyo Stock Exchange (collectively the JPX Group), and Nikkei jointly developed the index, which abandons traditional broad inclusion and market-cap weighting in favor of including only the most profitable and shareholder-friendly companies as determined by both quantitative and qualitative factors, with corresponding weighting.

Index constituents must have positive net asset value, and are weighted based on three-year average ROE ranking, three-year cumulative operating profit ranking, and market capitalization. In addition, the index constituents are ranked and weighted on such governance factors as International Financial Reporting Standards accounting adoption, independent board representation and the use of English-language earnings releases.

Japan’s Government Pension Investment Fund has announced its intention to shift some of its equity portfolio to the JPX-Nikkei 400 index, in addition to adopting a stewardship code for institutional investors. The new index also inspired companies such as Amada Co, a machine-tool manufacturer and member of Nikkei 225, to seek improved profitability and commit to improving corporate governance in order to present itself as a viable candidate for future inclusion in the JPX-Nikkei 400.

Evaluations and incentives

Evaluate internal and external asset managers with an emphasis on their process, behaviors, and consistency with longer-term expectations. Formulate incentive compensation with a greater weight on long-term performance.

The total return of a strategy over a relevant period (that is, the period most relevant for that strategy’s purpose) is ultimately the most important indicator of its performance. While intermediate evaluation of performance is necessary, it cannot be solely about movement in price given that short-term returns are highly unreliable indicators of strategy success and manager skill. To allow asset managers to focus on running their portfolios instead of worrying about career risk and asset retention, short-term assessments should focus on whether portfolio management is being carried out consistent with stated beliefs, and whether it aligns with expectations that have been agreed on ahead of time for the investment strategy, process, and outcomes.

Qualitative evaluation is extremely important in the initial due diligence of an asset manager and is at least equally important in the initial phase of the asset owner/asset manager relationship before a fully credible performance record can be established—that is, before skill starts to be distinguishable from luck. Well-selected managers should rarely be fired for short-term underperformance relative to quantitative measures. However, dismissal may be justified if the manager deviates significantly from the investment mandate without adequate transparency and explanation. Dismissal may also be justified if the fund manager’s organization fails to communicate its actions and performance effectively or has lost necessary competencies.

A sound qualitative evaluation of an asset manager should provide evidence of a long term-focused investing culture by addressing the following elements:

1. key personnel changes/corporate ownership
2. robustness of stated process and adherence to beliefs and philosophy
3. evidence of effective risk management
4. ability to coherently express ideas and effectively implement them
5. transparency of decision making and performance attribution
6. loyalty to research agenda
Asset managers themselves are increasingly adopting qualitative measures of performance against longer-term mandates. For example, Aberdeen Asset Management, a publicly held asset manager headquartered in the United Kingdom, primarily evaluates its managers based on their patient adherence to long-term process as observed by peers. And, State Street Center for Applied Research has developed an interesting behavioral framework of factors to identify key behaviors and patterns that may help define true skill in the asset-management industry.15

The effective evaluation time period is critical to ensuring alignment between asset owners and asset managers. A study of pension-plan sponsors that fired their asset managers showed that if the asset owners had retained these managers, their excess returns over benchmarks would have been no worse on average and often better than those delivered by the managers they then hired.16 In addition, the asset owners would have saved the substantial transaction costs of a manager transition, which often range from 1 to 2 percent of the assets involved.

Many asset owners set long-term objectives but then evaluate based on short-term results. Yet, while a long enough horizon should be used to recognize long-term investing objectives, evaluations must also consider the reality of an individual asset manager’s circumstances (for example, working conditions, employment life span, ambitions for career trajectory, career risk, and so on) that may influence his or her behavior in the shorter term.

**We recommend balancing asset-manager evaluations with both quantitative and qualitative factors by:**

- including the total return relative to the objectives of the asset owner over a stated period (that is, meet or beat the absolute or strategy target)
- evaluating quantitative performance over a minimum of five-year rolling windows
- ensuring that performance fees or internal incentive compensation are earned only at the end of each five-year time horizon. For example, a privately held asset manager that manages concentrated portfolios driven by fundamentals, the most senior half of the investment team owns direct stakes in the firm. These team members do not receive annual bonuses. Instead they receive portions of the incentive fees earned by the firm, which are paid out (primarily) at the end of rolling three- and five-year periods
- relying on qualitative evaluations specifically tailored to assess the adhesion to or success of stated investment beliefs or manager strategy during intervening periods

Financial incentives for asset-management organizations may need to be restructured to achieve better alignment with long-term performance. To align their interests more closely, asset owners and managers should carefully consider the balance between management and performance fees. A lower management fee acts as a “keep the lights on” reimbursement. The performance fee is earned progressively over time as credibility grows and paid out over the longer term.18 It is based on demonstrable value added and can ultimately lead to greater cumulative total fees for sufficiently good performance. For example, Caisse de dépôt et placement du Québec prefers to compensate external asset managers using a mix of low management fees and rolling four-year incentives.

In turn, asset managers can encourage longer-term behavior within their own organizations through their incentive compensation structures.

**Idea in action:**

**Incenting long-term behaviors and performance at asset managers**

A large, privately owned asset manager headquartered in the United States determines staff bonuses based on both quantitative and qualitative measures.

The quantitative component rates one-, four-, and eight-year performance on a rolling basis, weighted toward the longer periods. The qualitative component incorporates a 360-degree review process that evaluates the portfolio manager or analyst’s overall contribution to the investment process.

The review emphasizes criteria related to communication and collaboration within the team. In addition, a select group of employees shares in the annual profits of the organization, with the award based on contributions to investment results, investment process, and operational effectiveness. The opportunity for ownership in the firm also reinforces long-term behaviors.
Mandates

Use investment-strategy mandates not simply as a legal contract but as a mutual mechanism to fully align the asset managers’ behaviors with the objectives of the asset owner.

Asset owners typically use the term “mandate” to denote a contract with an asset manager that outlines basic investment guidelines, the terms and conditions of engagement, the fee structure, and possibly the assigned benchmark. Mandates describe the playing field as well as the rules and the rewards. They are the primary formal tool to mitigate principal-agent problems that may arise between asset owners and managers. The goal is to set out clear and reasonable short- and long-term expectations for both parties. To focus asset managers on long-term performance, mandates must go well beyond the typical legalistic contract. Ideally, the mandate should clarify the asset owner’s purpose and expectations for the strategy and the asset manager’s investment philosophy and approach.

To align the interests of asset owner and asset manager on long-term value creation, mandates should provide clarity on the following:

1. Investment philosophy and strategy (for example, investment beliefs, risk appetite, management approach, measures of success)
2. Investment processes, including observable portfolio metrics that indicate the manager is acting according to expectations
3. Investment and risk guidelines and limits
4. Terms and conditions (for example, benchmark choice, compensation structure/scheme, and other potential contractual requirements such as lockup periods, redemption restrictions, clawbacks, and need for asset manager to have “skin in the game”)

Mandates should describe a number of distinct quantitative parameters and also emphasize qualitative factors. Such quantitative and qualitative considerations include:

**Quantitative**

Specific objectives such as generating cash or sustaining a spend program, risk metrics, success measures, reporting and monitoring, compensation and incentive structure

**Qualitative**

Enterprise culture, manager succession planning, expected nature and level of the asset manager’s interaction with investee companies

Outlining qualitative factors in particular can help ensure that the asset owner’s long-term focus is reflected all along the value chain, right to the corporate boardroom table:

- **Minimizes** agency issues through partnership agreement
- **Maximizes** impacts through active ownership
Conclusion

We believe institutional investors have a fiduciary duty to invest in the long term since long-term investing contributes significantly to the process of value creation through the investment value chain. An ideal market will always include a mix of investors with different investment time horizons and investment strategies. Long-term investors can take the opportunities and reap the rewards foregone by short-term investors. By investing countercyclically, long-term investors strengthen the market itself. Those who can invest long term should invest long term. Institutional investors should deliberately determine and allocate an organizationally meaningful proportion of their assets to long-term strategies—and reorient their portfolio structure and strategies to do so.

While institutional investors should build and maintain a culture that rewards and encourages long-term thinking, long-term investors cannot and should not completely ignore short-term opportunities. As appropriate to meet the needs of their beneficiaries, investors need to optimally balance their overall portfolio across a mix of short-, medium-, and long-term strategies. Nevertheless, we believe there is a clear need to shift the focus of equity investing away from its current heavy emphasis on predicting short-term stock-price movements. We believe that investors and businesses alike can create greater and more sustained value by adopting strategies that harvest the fruits of long-term earnings growth as well as benefit savers, beneficiaries, capital markets, and economies.

This paper presents a summary of ‘The Long-Term Portfolio Guide: Reorienting portfolio strategies and investment management to focus capital on the long term,’ FCLT, March 2015, white paper.
Notes and references

1 Institutional investors include asset owners (pension funds, sovereign-wealth funds, mutual and other investment funds, life-insurance companies) and asset managers (investment-management firms and internal portfolio managers at asset owners).

2 The Reorient Portfolio working group, comprised of investment professionals from BlackRock, Caisse de dépôt et placement du Québec, Canada Pension Plan Investment Board, Capital Group, GIC, New Zealand Superannuation Fund, Ontario Teachers’ Pension Plan, PGGM, Washington State Investment Board, and Ronald O’Hanley, former president, Asset Management and Corporate Services, Fidelity Investments.

3 While some of the ideas we present in this paper can be applied more broadly to the total portfolio, we address the management of institutional investment portfolios and mutual funds, with particular focus on public equities. Investments in publicly-traded equities and bonds are the single biggest component in the collective portfolio of institutional investors (see Serdar Çelik and Mats Isaksson, “Institutional Investors as Owners: Who Are They and What Do They Do?,” OECD Corporate Governance Working Papers, Number 11, December 2013, oecd.org). We believe many public companies continue to exhibit excessive short-termism, which is often reinforced rather than countered by the behavior of many institutional investors. While short-termism may also exist in private companies, we believe it is less prevalent. In fact, long-term orientation is often cited as a major advantage of private companies. As a result, we do not place particular focus on this asset class. Nor do we focus on asset classes such as real estate, infrastructure, timberland and agriculture that yield inherently long-term payoffs.


5 It is useful to distinguish between beliefs and facts, as New Zealand Superannuation Fund does. See Investment Beliefs, Guardians of New Zealand Superannuation, New Zealand Superannuation Fund, October 2014, nzsuperfund.co.nz.

6 “Strategic tilting” is a technique that New Zealand Superannuation Fund (NZSF) uses to add value to its reference portfolio (that is, NZSF’s definition of a low-cost easily accessible benchmark). The technique involves “dynamically adjusting the long-run risk profile embodied in the NZSF’s reference portfolio” by adjusting/tilting broad listed asset-class holdings relative to their weights in the reference portfolio and according to their relative expected returns over near- and medium-term horizons. However, the signals are not followed automatically, and a substantial judgmental overlay is applied. The academic literature suggests that markets go through boom and bust cycles, which is corroborated by our investment experience. NZSF’s internal modeling supplemented this with the finding that tilting performed no worse than a static asset-allocation strategy over the long run. See Investment Beliefs, Guardians of New Zealand Superannuation, New Zealand Superannuation Fund, October 2014, nzsuperfund.co.nz.


*Benchmark design for an active investment process*, Norges Bank Investment Management, June 2014, nbim.no.

According to a survey conducted by Nasdaq OMX Advisory Services in June 2014, in which 21 investment professionals globally were polled about an ideal investment horizon for a typical long-term investor, four in five respondents agreed that long-term investors should have an investment horizon of at least five years, while nearly two in five preferred an even longer time frame of at least ten years. See Long-term Investing Gathers Momentum, Nasdaq OMX Advisory Services, July 2014, qnasdaqomx.com.

For a long-term investor, the most important criterion is the sustainable growth of long-term earnings per share. All things being equal, a company with healthy operating performance (return on equity, return on invested capital) and good growth prospects is a candidate for generating sustainable value.

An absolute return-focused strategy requires only 25 to 30 stocks, each with an average degree of noncorrelation with the others, to diversify away much of the nonsystematic risk in an equity portfolio. See William F. Sharpe, “Risk, market sensitivity, and diversification,” *Financial Analysts Journal*, January–February 1995, Volume 51, Number 1, pp. 84–8, cfapubs.org. The benchmark index should contain five to ten times that number of stocks.


For quantitative insights on evaluating strategies and performance, see Richard Grinold and Ronald Kahn, *Active Portfolio Management: A Quantitative Approach for Producing Superior Returns and Controlling Risk*, second edition, New York, New York: McGraw-Hill, 1999. For example, “… to determine with 95 percent confidence that a manager belongs in the top quartile (IR = 0.5) will require 16 years of observations.”


See David L. Donoho, Robert A. Crenian, and Matthew H. Scanlan, “Is patience a virtue? The unsentimental case for the long view in evaluating returns,” *Journal of Portfolio Management*, Fall 2010, Volume 37, Number 1, p. 115, iijournals.com. The authors use a Monte Carlo simulation of 10,000 investment managers to show that institutions that rely on longer performance horizons of more than five years are more likely to select and stay with better managers than institutions that use shorter performance horizons.

19 As far back as 1976, Jack Treynor proposed that “opportunities for long-term investors will reside where market prices are set by short-term investors who make common mistakes (correlated errors). Such mispricings are more likely to occur with respect to ideas that require reflection, judgment and special expertise for their evaluation and hence travel slowly.” See Jack L. Treynor, “Long-term investing,” *Financial Analysts Journal*, May/June 1976, Volume 32, Number 3, pp. 56–9.