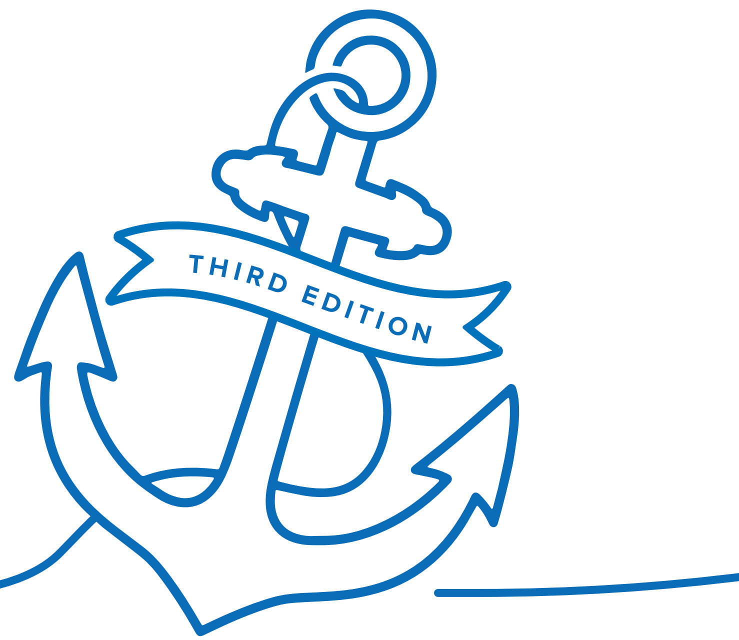
FCLTGLOBAL
FOCUSING CAPITAL ON THE LONG TERM



REPORT

Institutional Investment Mandates

ANCHORS FOR LONG-TERM PERFORMANCE

FCLTGLOBAL

JULY 2022

Focusing capital on the long term to support a sustainable and prosperous economy.

Millions of people around the world are saving money to meet personal goals—funding a comfortable retirement, saving for someone's education, or buying a home, to name a few.

The funds to support these goals are safeguarded by institutional investors—pension funds, sovereign wealth funds, insurers, and asset managers—who invest in companies for the prospect of growth and security. These savers, their communities, and the institutions that support them make up the global investment value chain, and each benefit from long-term decisions in different ways.

Data shows that long-term-oriented investors deliver superior performance, and long-term-oriented companies outperform in terms of revenue, earnings, and job creation. But despite overwhelming evidence of the superiority of long-term investments, short-term pressures are hard to avoid. A majority of corporate executives agree that longer time horizons for business decisions would improve performance, and yet half say they would delay value-creating projects if it would mean missing quarterly earnings targets.

Today, the balance remains skewed toward short-term financial targets at the expense of long-term value creation.

FCLTGlobal's mission is to focus capital on the long term to support a sustainable and prosperous economy. We are a non-profit organization whose members are leading companies and investors worldwide that develops actionable research and tools to drive long-term value creation for savers and communities.

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This document benefited from the insight and advice of FCLTGlobal's Members and other experts. We are grateful for all the input we have received, but the final document is our own and the views expressed do not necessarily represent the views of FCLTGlobal's Members or others. The information in this article is true and accurate to the best of FCLTGlobal's knowledge. All recommendations are made without guarantee on the part of FCLTGlobal. Reliance upon information in this material is at the sole discretion of the reader; FCLTGlobal disclaims any liability in connection with the use of this article.

Executive Summary

The relationship between asset owners and managers presents a classic time-horizon mismatch.

The asset owner has a specific set of investment objectives that correspond to its stakeholders, liabilities, responsibilities, return goals, and risk tolerance. The manager, in turn, has a different set of stakeholders. As a result, the goals and internal incentives facing its portfolio managers and business leaders are likely to differ substantially from those of the asset owners whose capital it manages.

Therein lies the challenge: how to ensure ongoing alignment of incentives and goals between two distinct institutions, often over a long period of time.

To address this challenge and facilitate long-term alignment, FCLTGlobal has developed research and tools in collaboration with leading global investors. This paper—our third edition since 2015—is the culmination of our extensive efforts in this area. It provides steps and tools for asset owners and managers to consider when designing long-term investment mandates.

FCLTGlobal's Model for Long-Term Contract Provisions forms the core of this work. The model offers a starting point for contract negotiations between asset owners and managers, helping them define mandate terms that build trust, ensure alignment, and advance asset owners' long-term goals.

A full suite of tools included in this paper further complement this model by providing investors with a framework that promotes alignment throughout every stage of the investment relationship.

To start, asset owners can use our *Statement of Purpose and Responsibilities for Investors* template to document their investment objectives and share with investment partners (pg. 19). From there, asset owners can complete the *Finding the Right Match for the Long Term: Due Diligence Top Ten List* to ensure that potential managers are focused on and capable of fulfilling these long-term investment objectives (pg. 20).

After awarding a mandate, asset owners can select from the menu of terms included in the *Long-Term Model for Institutional Mandates: Contract Provisions*—an extensive list that broadly covers sustainable investment mandates and provisions for commingled funds, as well as core long-term provisions (pg. 21). *The Long-Term Model for Institutional Mandates: Key Performance Indicators (KPIs)* provides an enhanced set of KPIs that can be used in conjunction with our contract provisions to help achieve agreement on how to measure success over the long term (pg. 23).

The Aligning Expectations for Long-Term Success: Onboarding Checklist helps ensure that the relationship between the asset owner and manager is established in line with mandate expectations and promotes transparency (pg. 25), while the *Trust but Verify: Manager Scorecard* provides the asset owner a consistent method to evaluate the manager's performance, based on specific priorities, over time (pg. 26).

To see our model and tools in practice, we have included a series of case studies from select FCLTGlobal members. These case studies showcase how members have put some of these ideas to work, as well as the results they achieved. In some cases, simple changes led to significant long-term success.

By following our model for long-term contracts, as well as our associated tools, investors can ensure that the relationship between asset owners and managers is anchored with clear objectives and expectations, while avoiding surprises and averting common default patterns of short-term performance evaluation.

Introduction

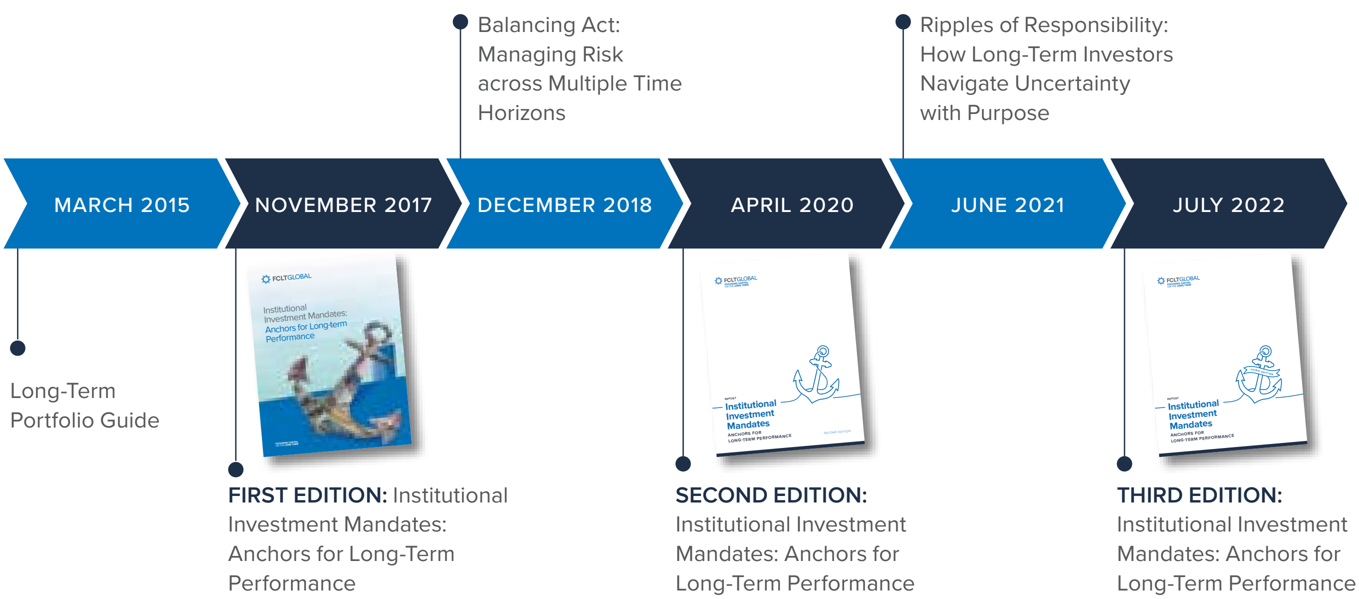
Alignment on long-term incentives and goals between two distinct institutions, asset owners and managers, requires ongoing governance and communication—qualities that can falter over time. Nearly a thousand investment professionals surveyed by State Street in 2019 affirmed these challenges: "Seventy-seven percent of asset owners said they were concerned that short-term incentives were not being aligned with long term objectives... More than half of managers (57 percent) said the same."[1] Additionally, 82 percent of asset owners and managers expressed concerns with short-term relationship impediments and admitted that their concerns were not being adequately addressed.

Asset owners' best approach to overcoming these challenges is to employ a sound due diligence process combined with investment mandate design—the contract that defines specific terms and parameters and governs the relationship.

The asset owners and managers involved in our Focusing Capital on the Long Term initiative wrote in the Long-Term Portfolio Guide that the investment management contract is "a mutual mechanism to align the managers' behaviors with the objectives of the asset owner, not simply a legal contract."[2]

This report builds on that principle and offers a long-term model for investment contract terms, with the goal of providing a starting point for mandate negotiations that emphasize long-term provisions rather than the short-term incentives that are all too common in today's investment contracts.

FCLTGLOBAL'S PUBLISHED RESEARCH AND TOOLS TO SUPPORT LONG-TERM ALIGNMENT BETWEEN ASSET OWNERS AND MANAGERS.



The Investment Mandate

Among the most important elements in ensuring that institutional investor partnerships fulfill long-term objectives are the "mandates"—the investment management contracts between asset owners and managers. Mandates define the relationships between asset owners and managers and align the managers' behaviors with the asset owners' objectives. Mandates play a crucial role in ensuring the success of these relationships over time.

Translating long-term intentions and objectives into investment management mandates involves rethinking the primary provisions applicable to public equity investment strategies and the key performance indicators (KPIs) used to evaluate managers. Quarterly performance is an easy measuring stick but is unlikely to provide much information about underlying capabilities or future prospects over the duration of an investment mandate.

The reasons that an owner chooses to invest with a manager can lead to the development of KPIs that may be monitored and discussed throughout the relationship, facilitating a deeper understanding of the manager's strengths and weaknesses and improving the likelihood of success. Investors who responded to State Street's survey pointed to "short-termism" as the industry's top-ranked problem, and asset owners—principals or clients—in particular expressed this belief.

While each investor will undoubtedly use different contract provisions and KPIs to fit their individual goals, and shorter-term provisions may be completely appropriate for shorter-term investment allocations, starting with a long-term mindset is more likely to lead to a mutually beneficial, long-term relationship.

Shaping mandates with provisions specifically oriented toward long-term goals can help build stable, lasting investment partnerships and, if designed properly, improve long-term performance.

Here are a few questions for institutional investors to ask as they negotiate a mandate:

- **Do the incentives built into the mandate support a long-term relationship? For example, fees that decline with the longevity of the partnership rather than with the assets under management may provide asset owners incentives to be more patient through periods of underperformance.**

- **Do the ongoing communications concentrate undue attention on short-term results? Simple changes—such as emphasizing long-term returns in performance reports, highlighting annual (or multi-year) instead of quarterly performance, and defining a rebalancing policy—may counteract the impulse to overreact to short-term events.**

- **Is the focus on leading or lagging indicators of performance? An owner may gain more insight into future performance from disclosure of changes in the firm or team, shifts in the investment process, and results measured by KPIs than from current or past performance.**

- **Do the mandate terms reward long-term investing and mitigate the common "buy-high, sell-low" pattern of chasing performance? It is tempting to invest in managers after strong performance and terminate them after poor performance, leading asset owners to chase rather than capture strong returns. Contracts that renew on a long-term calendar and place explicit caps on manager asset capacity can support a process driven by long-term factors instead of short-term performance.**

Preparing for Long-Term Mandates

Institutional investors can focus on the long term together only when they first have that focus individually. Investors who helped to found FCLTGlobal named the core elements of this focus in the 2015 Long-term Portfolio Guide.[2] Their view is as timely and insightful today as it was then.

We first provided the toolkit Long-Term Model for Institutional Investment Mandates in 2020 to facilitate this "mutual mechanism" that these leading long-term investors emphasized.

Before seeking to establish a long-term relationship, it is critical for asset owners to work internally to set investment policies, including beliefs, risk appetite, benchmarking processes, evaluations, and incentives. Balancing Act: Managing Risk across Multiple Time Horizons includes tools for setting objectives, strategy, and decision management at the portfolio level.[3]

The Due Diligence Process

After establishing internal investment parameters, the start of any long-term relationship is a strong due-diligence process. Designing mandate provisions comes after that process and is not a substitute for effective due diligence. No fee structure or contract term will make up for hiring the wrong manager.

Asset owners can only orient for the long term if they hire long-term-minded managers. The provisions of their mandate affect how well they can preserve that focus, but those terms cannot reorient short-term managers toward the long term. The inverse also is true: long-term managers can realize this focus only when clients share their intentions.

In the Long-term Portfolio Guide, FCLTGlobal's founding investors definition of long-term investing can serve as a key, high-level reference for due diligence:

- **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 by, 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 or benchmarks (it is not a "beauty contest"), but focuses on long-term expectations and outcomes**

Of course, contract terms do matter once an asset owner and manager are ready to enter a long-term-minded relationship. Writing or revising mandate contracts to ensure better focus is essential once an investor has defined its own focus and done its diligence of potential partners.

Top Ten List for Long-Term Mandates

Mandate terms and conditions can drive long-term or short-term behavior, helping or harming efforts to fulfill asset owners' objectives. Based on our series of working groups with leading global asset owners and managers, we offer this list of questions to orient investment mandate negotiations in a long-term direction:

1 FEES

Do the fees and fee structures reward a long-term focus? Discounts that increase with longevity may strengthen asset owners' commitment and give managers more flexibility to make long-term investments.

2 BENCHMARK

To what extent does benchmark-relative return capture a specific strategy's performance? Are any other metrics as important, such as absolute return or liability matching?

3 CONTRACT TERM

Does the contract encourage long-term commitment and protect against overreacting to short-term events? For instance, a three- to five-year contract term may set longer-term expectations than an at-will contract and still give the owner discretion to terminate, if necessary.

4 REDEMPTIONS

Is the manager able to commit to the long-term strategy while maintaining the liquidity needed to meet permissible redemptions? Would allowing in-kind redemptions help to strike this balance?

5 MANAGER OR STRATEGY CAPACITY

Does the investment strategy have asset capacity limits? Noting capacity limits in the contract may instill discipline and mitigate the common pattern of committing assets following strong performance.

6 REPORTING

Do the tables and commentary highlight long-term investment risks and future investment prospects? Reporting could discuss long-term returns first and primarily comment on annual or longer performance.

7 PROJECTIONS

Have the negotiations and discussions included explicit performance projections across multiple timeframes to account for the differences between short- and long-term risks? If so, how?

8 ACTIVE OWNERSHIP

Is part of this strategy to add value through activities beyond portfolio-specific decisions? These activities may include maintaining dialogue with portfolio companies and strategically casting proxy votes.

9 DISCLOSURES

Does the manager conduct business in a way that is consistent with long-term investing? Disclosing personnel or process changes may offer better leading indicators of future performance than past returns do.

10 EVALUATION

Does the contract establish a plan for how the owner will evaluate the manager? For instance, scheduling regular evaluations may enable more open communication than watch-listing during periods of underperformance.

Asset owners and managers need to ensure that the answers to these questions are coherent so contract terms are complementary and support long-term investing (further considerations and examples for each mandate term can be found in the Contract Provisions matrix on page 21). Above all, do the terms enable the manager to commit capital according to the strategy's desired time frame, or is there a mismatch in incentives, liquidity, or elsewhere?

Model for Long-Term Contract Provisions

Long-term investors select mandate provisions and KPIs for their relationship that are appropriate for the specific return, risk, and responsibility strategy that they share. They then ensure that these provisions are complementary and integrated into a cohesive package that provides the underpinnings of a long-term, mutually beneficial relationship.

To facilitate asset owners and managers with the details, we append two matrices in the *Institutional Investment Mandates Toolkit*.

Contract Provisions

In *Long-Term Model for Institutional Mandates: Contract Provisions* (pg. 21), we provide a menu of choices for key mandate provisions: fees, benchmarks, contract terms, redemption policies, asset capacity, projections, reporting requirements, expectations for active ownership, disclosures, and evaluation processes. We compare today's common standards, which tend to reflect a short-term mindset, to a longer-term starting point for negotiations. In parallel, we offer ideas on additional exploratory provisions to incorporate into long-term contracts, as appropriate. Contract provisions are relevant for separately managed accounts and commingled funds, with unique provisions described for the latter.

(Orienting mandate provisions for the long term is discussed in more detail in the next section.)

KPIs

In *Long-Term Model for Institutional Mandates: Key Performance Indicators (KPIs)* (pg. 23), we rethink the KPIs that asset owners use to evaluate managers. Asset owners select managers for their investment and business characteristics and their fit into the overall portfolio. Choosing KPIs that reflect these priorities can give asset owners better leading indicators of performance than backward-looking returns do.

Long-Term Mandate Contract Provisions

In this section, we discuss common contract provisions through the lens of long-term investing.

Fees are often at the top of asset owners' priority lists when discussing investment mandate terms. Today's norm is for asset owners to pay managers a fixed percentage of assets under management (AUM), a variable performance fee, or a combination of the two.

Managers who charge an AUM fee often offer asset owners discounts based on the size of the account. A discount based on longevity of the relationship may provide a longer-term incentive. An owner receives a benefit for patience and commitment, while the manager benefits from the comfort of a more reliable capital base, both of which may help them capture long-term premia.

Asset owners and managers who prefer to use a performance fee can incorporate long-term incentives by calculating performance over a multi-year period, such as three to five years, and using a hurdle rate that compounds with time accordingly.

Asset owners can also defer the performance fee to ensure that only long-term performance is rewarded. Deferring such a fee, rather than paying it and clawing it back in the case of future underperformance, lessens the possibility that the manager will become overly risk-averse during the later years of the contract.

The **benchmark** used to judge the success of an investment strategy understandably receives a great deal of scrutiny. Investors have yet to find a perfect benchmark to encourage long-term thinking. In fact, the selection of a benchmark, while important, appears secondary to many other provisions in terms of providing an incentive for long-term behavior. In other words, how the benchmark is used, and its reference time frame are more important than selecting a specific benchmark.

Another key component of a relationship is the **contract term**. Asset owners can usually terminate their relationships at will and without cause. While asset owners may appreciate maximum flexibility, at-will contract terms present several challenges. Asset owners may make shorter-term commitments to their managers than they expect their managers to make with their capital. They often "re-underwrite" relationships in response to short-term events, leading managers to overreact to such events.

Furthermore, when there is staff turnover due to departures or internal rotations, there may be no champion of an existing relationship, leading to mandate churn.

Setting a three- to five-year term with automatic renewals—provided that the manager continues to act in the best interests of the asset owner—may build the relationship with a long-term time frame, shifting the onus from reacting to short-term performance to evaluating progress towards long-term goals. These contracts may still offer wide discretion for termination, in contrast to strict lockups, so that asset owners can make the decision to terminate if circumstances warrant.

A manager's opportunity to **redeem in-kind** (in securities instead of cash) can also affect their ability to pursue long-term opportunities. It is challenging for a manager to undertake a long-term investment strategy, such as investing in a turn-around situation, if redemptions may require shorter-term liquidity than the underlying investments provide. The asset owners' ability to invest with a long-term outlook is similarly undercut if other investors in the strategy or fund can redeem prematurely. Clarifying in-kind redemption provisions and understanding their impact, if any, on the manager's strategy can improve alignment of long-term goals.

Discipline is a critical component of long-term investment-management relationships, including the discipline to keep assets under management within the boundaries of an investment strategy's **capacity**. Managers often have a financial incentive to grow assets in high-performing strategies beyond the level at which they can achieve long-term outperformance. Contracts can specify a strategy's capacity, in absolute terms or as a percentage of investable market capitalization, to help managers maintain that discipline over time.

Rather than focusing on quarterly performance, long-term asset owners and managers will want **performance and risk reports** to draw attention to the long term. Minor changes to standard reporting templates can help reframe the discussion, such as reporting long-term returns on the left of the page and short-term returns on the right. Focusing written commentary on long-term results—rather than on the quarter's events—and being transparent about trading and operational costs can also encourage discussion of issues that drive long-term success. While it is important to comply with GIPS requirements, including extrapolating statistics from one-month data, asset owners and managers can agree in the mandate document to produce, and focus on, supplemental reports that highlight the actual risk data, instead of extrapolations.

To thrive in the long term, investors also must survive short-term turmoil. One way to balance those competing perspectives is to include **projections** as part of the discussion process around a mandate. Today, up-front projections tend to be very limited, and often rote. Asset owners and managers may find it easier to maintain relationships when they have a shared view about the expected risks and returns across different time horizons—not just at the closing date but across the full pathway of their investment.

Active ownership or engagement with investee companies is important to many long-term investors. As part of the mandate process, asset owners can ask managers to detail their current practices for engaging with portfolio companies and for casting proxy votes. In doing so, they can ensure these policies are long-term in nature and match their own long-term goals. Reporting on active engagement and proxy voting, and relating outcomes to the investment strategy, reinforces how a manager actively influences corporate behavior, and long-term performance of portfolio companies.

Long-Term Mandate Contract Provisions (contd.)

Disclosures beyond performance also can play an important role in building a long-term relationship. Asset owners identify the most important components of the manager's investment and business operations during the due diligence process. Monitoring these factors for changes and defining relevant KPIs can deepen the long-term relationship and prevent unwanted surprises. Changes in firm ownership or the composition of the portfolio management, research, trading, and business management teams may be leading indicators of future performance. The mandate can provide a framework for asset owners and managers to commit to the operational and business KPIs to disclose.

Finally, delineating the **evaluation process** at the outset of the relationship can help asset owners better manage their own decision-making processes over the long term. For example, documenting and monitoring the reasons for hiring a manager beyond portfolio performance; meeting with managers routinely, rather than just in reaction to underperformance; and measuring expected transition costs before making a termination decision can all lead to better long-term decisions.

Exploratory Provisions

Our work generated several further questions for asset owners and managers that would like to explore additional ways to promote long-term thinking, including:

- **Could built-in rebalancing mechanisms counteract the typical performance-chasing cycle of fund flows?**
- **Would having a manager continue to report performance to the asset owner for three years after termination counteract asset owners' tendency to terminate managers after poor performance only to have performance rebound as it reverts to the mean?**
- **Would alternative benchmarks that explicitly incorporate long-term thinking, such as the S&P Long Term Value Creation Index or the asset owner's discount rate, be effective in encouraging long-term behavior? Liability-driven investments that reorient portfolios from merely return seeking to liability hedging?**
- **How can asset owners and managers generate constructive dialogue on portfolio managers' personal incentives, circumstances, and succession planning?**
- **Should performance reporting consider the economic indicators of companies in the portfolio in addition to financial return?**
- **How can managers use economic projections (e.g., aggregate revenue, earnings, portfolio modeled as a business) as leading indicators for financial returns?**
- **Should the asset owner define expectations of the manager's engagement with companies as part of the mandate, and then monitor and reward such engagement?**

Meeting the Mandate Responsibly

Asset owners and managers increasingly care about how investment returns are earned, not just what returns are. They care because expectations of long-term investors have expanded well beyond the usual notions of their purpose to include their broader impact on markets, society, and the environment. As a result, investors are increasingly identifying their core responsibilities, determining how expectations become responsibilities, and considering steps necessary to fulfill them.

Long-term investors change the mandate terms that they accept when they take on new or evolved responsibilities. The effect of accepting a responsibility can be to limit the investable universe, control externalities, require durability of performance over certain time horizons, or any combination of these standards. Any of these parameters can affect the fees, benchmarks, contract terms, redemption processes, capacity constraints, reporting, projection, ownership, disclosure, or evaluation practices of a relationship.

An investor's responsibilities are grounded in the organization's purpose. From there, long-term investment organizations can take at least five steps to operationalize their responsibilities.

Individual investors cannot fulfill their responsibilities alone. Meeting that standard depends on behaving consistently in relationships with investment partners. Ripples of Responsibility: How Long-Term Investors Navigate Uncertainty with Purpose includes a number of tools that investors can use to identify, accept, communicate, and fulfill responsibilities.[4] In particular, the Statement of Purpose and Responsibilities template is a communication device, part of the fifth step—"communicating about responsibilities," that can be shared with managers to provide greater context for investment mandates.

5 Steps

- TAKING INVENTORY OF CURRENT RESPONSIBILITIES
- ANTICIPATING EMERGING EXPECTATIONS
- PROCESSING EMERGING EXPECTATIONS
- FULFILLING NEW RESPONSIBILITIES
- COMMUNICATING ABOUT RESPONSIBILITIES

Embedding Real-World Objectives in Mandate Terms

Institutional investors do not exist simply to produce a certain financial return. Delivering that return is a means to some other objective. Achieving that objective is the ultimate and overarching metric.

Mandate terms are essential tools for achieving investors' objectives. They have limitless combinations and can be used to achieve a variety of real-world objectives, beyond the obvious one of optimizing investment returns. Examples of investment organizations' objectives include:

- **Providing for the well-being of retirees**
- **Preparing scholarship students to participate in the workforce and society**
- **Defending a currency**
- **Contributing to the economic development of a country**
- **Insuring the essential assets of people and companies**
- **Providing broad access to markets for those who would not otherwise have it, and**
- **Pairing individuals' and institutions' savings with businesses that can innovate and grow.**

Roughly speaking, these are the purposes of a pension fund, a university endowment, a central bank's investment arm, a sovereign wealth fund, an insurer, and managers, respectively.

Effective mandate agreements reflect such real-world objectives. Long-term investors require long-term mandates to fulfill their purposes, but the job is not done merely by having these sorts of agreements.

Effects that long-term asset owners and managers seek to have in the real world are possible only when integrated into the mandate because it is this document that sets the incentives and parameters for their shared behavior.

For instance, a multi-racial collaborative of managers speaks powerfully about the need for equitable investing to center first on management fees, while these emerging managers establish their business, before shifting more toward performance fees.

Other investors increasingly realize the way in which volatility smoothing within the portfolio creates income volatility in the real economy—and that they will have to tolerate more short-term portfolio volatility to control this externality on people's incomes around the world.

To illustrate how mandate provisions can support real-world goals, the sidebar offers hypothetical terms for a mandate driving a net zero 2050 commitment.

A NET ZERO 2050 MANDATE

For investors, reorienting a portfolio to meet a net zero 2050 climate commitment means letting go of the usual investment beliefs that markets are mean reverting, underpinned by independent and identically distributed price movements, and replacing it with an expectation of permanent trending behavior. Assets that conflict with a net zero 2050 commitment will not rebound, in this view, and assets that come into favor will not fall back to ground. This switch from mean reversion to trending assumptions has ramifications for every single provision in a mandate agreement. For example:

Fees
Design performance fees in a way that both encourages fulfilling the net zero 2050 commitment while also netting out the trending nature of performance due to it.

Benchmark
Add a benchmark of climate impact, grounded in science-based targets, as a complement to the risk-return benchmark

Contract Term
Select a time scale that at least is compatible with, or even supportive of, the chosen pathway for fulfilling this commitment.

Redemptions
Gate redemptions to see through operational engagements with portfolio companies to transition them to a cleaner footprint.

Manager or Strategy Capacity
Frame capacity in AUM terms but also in terms of the mode of fulfilling the net zero 2050 commitment, for instance capacity for operational engagement or capacity for proxy contestation

Reporting
Conform reporting to benchmark adjustments associated with this net zero 2050 commitment.

Projections
Adjust or replace the statistical distribution currently used for making projections with one that accommodates the trending element in valuations attributable to climate change and climate commitments.

Active Ownership/Engagement
Add detail specific to the net zero 2050 commitment.

Other Disclosure
Cross-tabulate all changes to the investment team in terms of climate competency.

Evaluation Process
Document climate-related rationales among the hiring reasons and evaluate performance accordingly, consistent with all other hiring reasons.

Note that these general provisions are some, but certainly not all, of those that would be needed to operationalize a net zero 2050 climate commitment in the context of external money management. The purpose in listing them is to illustrate why mandate provisions are crucial for achieving the goals of a relationship.

Adjusting Performance Reporting[5]

Adjusting mandate agreements to focus more on the long-term involves changes that seem insignificant but may yield outsized results. Reporting investment performance in reverse order, beginning with long-term returns and ending with quarterly returns, is one such change. It won't grab headlines—it might even elicit shrugs—but it's grounded in research about how people consume information.

Hermes, now known as the International business of Federated Hermes, and CalSTRS, along with OTPP, Kempen, MFS, and NEO Investimentos, are leaders with respect to long-term performance reporting.

Per a profile in P&I[6]:

> *beginning at the end of May [2017], Hermes Investment Management will lead client reports with 10-year performance numbers, rather than shorter-term figures. Eoin Murray, head of investment at the £30.8 billion ($39.7 billion) money manager, said the new approach is just part of helping investors think long term. "There's much more information in general now incorporated within our reports that reflects our approach to responsible investing," he said.*

The California State Teachers' Retirement System's (CalSTRS) reporting to its trustee board is another prime example.[7] CalSTRS focuses trustees' discussion on the long-term, rather than the most recent quarter, by beginning the report with 10-year performance. This accommodates CalSTRS' performance reporting to the "framing effect": a known and studied tendency of people to ground an entire deliberation in terms of the first-encountered bit of information. CalSTRS'—and all other investors'—ability to have an effective oversight conversation depends on having the right time frame and reversing the order of reporting is a simple way to achieve this alignment for long-term investors.

The Washington State Investment Board (WSIB) took similar measures.[8] Monthly performance reporting was eliminated, while 20-year and since-inception reporting was added. Reporting also introduced a comprehensive risk framework that shifted emphasis from volatility—in the generic sense—to a customized view of risk relative to key long-term objectives.

Brazilian manager Neo Investimentos also implemented this reverse order when reporting their performance to all their clients several years ago.

According to co-founder Henrique Alvares,' Neo uses this technique as a way of making a first impression and emphasizing to client investors who they are:

> *"When we saw FCLT's recommendation to switch the reporting of financial returns from longest to shortest, we immediately applied it. The emphasis we put in our longterm investment approach is now better understood by our audience, in a very simple and straightforward way" he said.*

Conclusion

Long-term asset owners and managers already have used the ideas in this paper to put significant assets to work in longer-term mandates that support their stated desire to focus on the long term. As more and more investors make this choice, we expect that their long-term behavior can translate across the investment value chain to influence corporations' business and capital allocation decisions. Ultimately, a shift toward the long term across the investment value chain can help foster improved economic growth.

FCLTGlobal believes that the mandate agreement is one of the most fundamental tools for influencing long-term investment behavior. As such, we may continue to update these mandate terms as our research identifies additional opportunities for using this tool to encourage more long-term behavior.

The mandate sets the parameters of the investment relationship and defines the incentives that guide the asset owner and manager. Well-designed mandates explicitly integrate provisions that reflect long-term objectives. By conducting effective due diligence and incorporating long-term objectives into the initial contract, asset owners and managers can help ensure fruitful investment partnerships that both satisfy their needs and support the productive long-term allocation of capital across the investment value chain. FCLTGlobal's Long-Term Model for Institutional Investment Mandates provides a starting point for negotiations and helps investors define mandates that are in line with their long-term goals.

FCLTGlobal anticipates that asset owners and managers will adapt these provisions to their own circumstances to encourage long-term behavior. Many of these provisions are already in use in various forms today, and we would appreciate feedback on your experience in implementing these and other ideas at Research@FCLTGlobal.org

Institutional Investment Mandates Toolkit

Shaping mandates with provisions specifically oriented towards long-term goals can help build stable, lasting investment partnerships and, if designed properly, improve long-term performance.

Mandates set parameters of the investment relationship and define the incentives that will guide the asset owner and manager. Well-designed mandates explicitly integrate provisions that reflect long-term objectives. By incorporating long-term objectives into the initial contract itself, asset owners and managers can help ensure a fruitful investment partnership that satisfies the needs of both parties and supports the productive long-term allocation of capital across the investment value chain.

Investors can take a number of actions to ensure the relationship between an asset owner and manager is set up to succeed prior to writing an investment mandate. Investors can also rely on certain processes to maintain the relationship going forward. The tools provided in this toolkit (summarized on the following page) were designed by FCLTGlobal and our members to help investors develop long-term goals and facilitate alignment through every stage of the relationship.

Together, these tools provide asset owners and managers a holistic picture—from the inception to fulfillment of the mandate. These tools can be used separately and selectively during any step of the way. Writing investment mandates sets the parameters of the relationship but should also provide the needed space for managers to add value and to be innovative in their approach to meeting expectations, taking advantage of the diversity of a manager's capabilities.

Statement of Purpose and Responsibilities for Investors

VERSION FOR ASSET OWNERS TO SHARE WITH MANAGERS

FCLTGlobal has developed the following example statement to communicate externally about an investor's responsibilities. Among other uses, it can be posted on organizations' websites or shared with investment partners. We have provided illustrative answers, but these are not intended to be exhaustive or comprehensive.

________________ is a ________________ asset owner organization with a
INSTITUTION NAME PUBLIC/PRIVATE

________________ investable universe based in ________________. We invest the assets of
GLOBAL/NATIONAL JURISDICTION

________________ valued at ________________ as of ________________. Our purpose
SAVER(S) $ / € / £ / ¥ DATE

is to ________________. This purpose is the point of reference that we use for evaluating all our work,
PURPOSE

including the work that we do together with you.

Our organization is governed by ________________ fiduciary directors with backgrounds as
NUMBER OF

________________. This body approves our investment
INVESTMENT PROFESSIONALS / FUND SPONSORS / BENEFICIARY REPRESENTATIVES

beliefs, sets our asset allocation, monitors our risk management, and oversees fulfillment of our organization's responsibilities. It ________________ approve portfolio allocations or individual manager selections.
DOES/DOES NOT

We need to earn a ________________% rate of return over ________________ years to fulfill our purpose.
NUMBER NUMBER

We monitor risks in this effort primarily using ________________
STRESS TESTS, SCENARIO EXERCISES, LIQUIDITY MONITORING,

________________.
STATISTICAL PROBABILITIES, MULTI-HORIZON CONSTRAINTS, BENCHMARK TRACKING ERROR

We must earn this return and manage these risks consistent with the responsibilities established by our sponsors, savers, and other stakeholders. These responsibilities currently include the following:

- ________________
- ________________
- ________________

Fulfilling these responsibilities may require making trade-offs. Our role in this relationship is governance and oversight. We have delegated management discretion to you. We need your decisions about responsibility to be transparent so we can calibrate our own trade-offs related to responsibility and monitor the continued fitness of our relationship. Accordingly, we expect you, as our managers, to surface new or evolving areas of responsibility for our consideration as they come to your attention.

Our reputation rests on yours, and yours rests on ours. Thank you for partnering with us to work well together, in a way that lives up to the standards we have set for ourselves.

Finding the Right Match for the Long Term

DUE DILIGENCE TOP TEN LIST

In addition to a typical due diligence questionnaire or RFP, which are essential for gathering information and for thoroughly completing the due diligence process, FCLTGlobal recommends ten considerations that can help focus discussions with prospective managers and determine whether the manager is long term or not. It is crucial to achieve alignment early in the process and to make sure there is an “opportunity fit” between the asset owner and manager – on philosophy, investment beliefs, and long-term value creation.

Top Ten Considerations

1 Investment Strategy

- Does the manager’s investment thesis – the core element of its ability to add value – reconcile with the stated investment strategy, particularly related to long-term opportunities and risk?

2 Repeatability

- Is the manager’s ability to add value repeatable and sustainable over the long term and supported by a strong organizational culture of long-term investing?
- Does the manager have the talent and diversity to achieve their investment thesis?

3 Risk Management

- Does the manager utilize a multi-horizon approach to risk management and has this approach been consistent through periods of market stress?

4 Active Ownership and Engagement

- How does the manager add value through stewardship, active ownership, and engagement, and does this relate to the manager’s investment thesis?
- Are there examples that can be shared?

5 Proxy Voting

- Does the manager use proxy advisors? If so, what is their process and criteria for selecting and using these services?

6 Fees

- In what way are investment management fees aligned with client outcomes?
- Will the manager accommodate fee arrangements based on FCLTGlobal’s Long-Term Model for Institutional Investment Mandates?

7 Compensation

- How is investment decision makers’ compensation linked to long-term investment performance through incentives or ownership vs. assets under management?
- Over what time horizon are incentives calculated?

8 External Affairs

- Does the manager seek to promote long-termism through engagement with policymakers, associations, investors, think-tanks, or other groups?
- Can these activities be disclosed?
- Does the manager actively participate in these initiatives or comment on policy proposals?

9 Investor Responsibilities

- How are investment opportunities and risks related to investor responsibilities (like net-zero commitments or DEI) identified and prioritized?
- How are sustainability factors integrated into the investment decision-making process?

10 Manager Responsibilities

- What responsibilities has the manager accepted (e.g., net-zero) in the course of doing business and earning returns for clients?
- How has the manager promoted greater diversity?

Long-Term Model for Institutional Investment Mandates

CONTRACT PROVISIONS

This matrix provides a menu of key contract provisions for mandates. We compare typical provisions, which tend to reflect a short-term mindset, to those promoting a longer-term approach, and offer ideas for exploratory provisions. The provisions are relevant for separately managed accounts and commingled funds, with unique provisions described for the latter.

The implementation of contract provisions can be facilitated through the use of other tools in this report, such as the *Finding the Right Match for the Long Term: Due Diligence Top Ten List, Aligning Expectations for Long-Term Success: Onboarding Checklist,* and *Trust but Verify: Manager Scorecard*. In addition to selecting provisions from this matrix, a clear objective for the mandate should be agreed upon between asset owners and managers, including return or excess return objectives over a specific long-term evaluation period.

	STATUS QUO	LONG-TERM MODEL	EXPLORATORY
Fees	• Asset-based fee (often declining with size) -Or- • Performance fees	• Discount AUM fee for mandate longevity • Discount AUM fee for relationship longevity • Calculate performance fee over at least three to five years with deferrals rather than clawbacks • Use compounding hurdle rate	• Discount fee for strategy-level AUM in engagement mandates • GP to invest deferred performance fees in fund • LP to co-invest in the GP • Use retainer fee to access investment ideas • Pay fixed-dollar fee *Commingled fund specific:* • Longevity discounts, rebates outside the NAV
Benchmark	• Cap-weighted reference index	• Cap-weighted or custom reference index, as appropriate • Clear understanding of the investible universe, including any exclusions, restrictions, or deviations from the benchmark	• Alternate index that includes long-term metrics (e.g., S&P LTVC Global Index) • Absolute return with capital call/return • Owner's liability discount rate or RFR+/CPI+ • Scenario- or projection-based
Contract Term	• At-will	• Set three- to five-year contract term with wide discretion to terminate • Continue contract at renewal points unless either party elects to terminate	• Narrow the discretion to terminate to focus on process discipline • Lockups for public equity mandates
Redemptions	• Limited ability to redeem in-kind	• Consider investment impact of manager's ability to redeem in kind	• Permit in-kind redemption for any long-term mandates *Commingled fund specific:* • Partial in-kind redemptions, side pockets • Exit fees that accrue to fund • Swing pricing • Quantify transaction costs and disclose to investors
Manager or Strategy Capacity	• Not contractually managed	• Cap strategy-level AUM for liquidity-constrained mandates in absolute terms or as a percentage of investable market capitalization	• Build in rebalancing mechanism to enable countercyclical investment flows, regardless of a fund's closed status

Long-Term Model for Institutional Investment Mandates

CONTRACT PROVISIONS *(CONTINUED)*

	STATUS QUO	LONG-TERM MODEL	EXPLORATORY
Reporting	• Include commentary and reporting focused on events of recent quarter • Make yearly and annualized reporting available • Provide Sharpe Ratio, Info Ratio, and other risk statistics extrapolated from monthly data	• Focus commentary and reporting on events of recent year and make quarterly reporting secondary • Elevate the prominence of commentary over performance data • Present table data from longest period on left to shortest period in right • Clearly report transaction and operational costs/rebates • Report on active engagement and stewardship outcomes • Report on investor responsibilities, e.g. net-zero progress • Report Sharpe Ratio, Info Ratio, and other risk statistics by tracking data over time (i.e. not from extrapolation)	• Provide commentary only on rolling annual or longer data (no quarterly commentary) • Report short-term performance less prominently (e.g., only through separate hyper-link)
Projections	• Provide performance projections of risk and return for the end point of the investment without a breakdown of the interim scenarios	• Provide projections of risk and return across multiple time horizons to reflect the differences between short and long-term risks (i.e., the long term is not just a series of short terms)	• Project returns based on economic parameters (e.g., aggregate revenue, earnings, or portfolio modeled as a business)
Active Ownership/ Engagement	• No consideration	• Manager details current engagement practice • Manager details proxy voting practices • Manager details their stewardship code commitments	• Asset owner specifies engagement expectations • Asset owner specifies proxy voting practices • Asset owner specifies stewardship code commitments
Other Disclosure	• Major changes in firm ownership or portfolio team	• Changes in firm ownership levels, portfolio or relationship team • Delineate KPIs and changes to them (see FCLTGlobal Key Performance Indicators (KPIs) template)	• PM investment in fund • Relationship team compensation structure • Key person succession and compensation • Open dialogue about key person's personal circumstances (e.g. material changes in health, marital status, personal residence, outside activities)
Evaluation Process	• Terminate based on short-term underperformance	• Commit ex-ante to parameters for out-of-cycle performance review • Document and monitor hiring reasons • Meet with managers on a predetermined schedule • Measure transition costs before terminating • Use the FCLTGlobal Manager Scorecard	• Concede one-year management fee for termination outside of process • Continue reporting and monitoring manager performance for three years after termination and evaluate decision

Long-Term Model for Institutional Investment Mandates

KEY PERFORMANCE INDICATORS (KPIs)

In addition to monitoring past investment performance, long-term asset owners monitor how managers manage portfolios and their businesses. Specifying key performance indicators (KPIs) from the KPIs matrix can provide structure for that monitoring. Investors may select among these disclosure terms based on their goals and are unlikely to use all of them in one mandate.

KPI	DESCRIPTION	KPIs COULD INCLUDE	
Portfolio	Stating investment beliefs and responsibilities and having metrics for them will allow an asset owner to determine if a manager is implementing the strategy consistently over the long term.	• Portfolio statistics on valuation, dividends, cash flow or growth • Money-weighted returns versus time-weighted returns • Style factors • Turnover • Drawdowns • Leverage ratios • Active share	*Other discussion items could include* • Setting performance indicators for investor responsibilities such as net-zero, DEI, etc.
Business and Personnel	Evaluating a manager's business structure and culture will help an asset owner determine if it is durable for the long term.	• Personnel turnover (internal and external) • DEI • Service level • Client concentration • Data and systems integrity issues • Trusted relationships with third-party providers	*Other discussion items could include* • Succession planning • Time element of compensation and promotion practices • Integration of long-term beliefs into research, trading, operations, legal, management, client service and other staff responsibilities
Operations	Asset owners need confidence that managers can implement their investment strategy consistently over the long term.	• Trading effectiveness (e.g., implementation shortfall, market impact) • Trade routing & venue performance • Mapping of issue priorities to proxy votes and their outcomes • Proxy vote assurance, including evaluation of missed or miscast proxy votes • Securities lending practices	*Other discussion items could include* • Technology solutions across firm operations

Long-Term Model for Institutional Investment Mandates

KEY PERFORMANCE INDICATORS (KPIs), *(CONTINUED)*

KPI	DESCRIPTION	KPIs COULD INCLUDE	
Investment Risk	Communicating proactively about the risk inherent in any investment strategy can help asset owners and managers maintain a long-term commitment through periods of difficulty.	• Demonstrated commitment to predetermined investment strategy when it is challenged by portfolio downturns • Results of simulated stress-test scenarios • Ex-ante parameters for internal review of performance • Strategy- and manager-level value-at-risk (interim and ending) relative to minimum viable capacity • Prospective redemption schedule	*Other discussion items could include* • Mismatch in liquidity between fund terms and underlying investment strategy and securities • Investment beliefs, strategic advantages, risk appetite statement, and rebalancing policy • Compatibility of risk parameters (interim loss and final shortfall) with expected return • Top risks of strategy • Assumptions about risk • Processes for managing myopic loss aversion, hyperbolic discounting, and other foreseeable behaviors • Scenarios for stress testing of returns in different environments and conditions of expected out- and under-performance
Engagement	Being an active and engaged owner can be a critical part of long-term investing.	• Frequency and number of company interactions, potentially including: – Asset-weighting engagements – Method (e.g., letter, call, in-person meeting, site visit) – Organized individually, collaboratively or by third-party – Principal interlocutor (e.g., lead independent director, committee chair, CEO, secretary, IR, etc.) – Principal lead staff person (e.g., PM, analyst, corporate	*Other discussion items could include* • Monitoring of material corporate governance, environmental and/or social issues
Impact	Long-term investors may evaluate managers on the broader impact of the investment.	• Stimulus to home market • Level of CO_2 emissions • Advancement of sustainable development goals	

Aligning Expectations for Long-Term Success

ONBOARDING CHECKLIST

Grouped among key areas of governance, incentives, metrics, and engagement, the onboarding checklist allows for effective communication between the asset owner and manager and sets parameters for the relationship to function transparently.

Onboarding Checklist	
Governance	☐ The asset owner and manager have agreed on a joint investment policy statement that reflects objectives, including return expectations, statutory and regulatory requirements, risk tolerance, time horizons, and investment guidelines with any exclusions.
	☐ The asset owner has shared with the manager accepted investor responsibilities, such as net-zero portfolio commitments; diversity, equity, and inclusion; or any other accepted responsibilities that could shape how the investor expects to earn their returns.
	☐ The asset owner has shared with the manager a list of, and the context surrounding, engagements, partnerships, or memberships with external bodies, such as the Net Zero Asset Owner Alliance, Institutional Investors Group on Climate Change, etc.
	☐ The asset owner has described how decisions for hiring and terminating external asset management agreements are made and who is responsible for them.
Incentives	☐ The asset owner has described how key persons responsible for portfolio decisions within their organization, such as asset allocation, hiring and terminating managers, are rewarded (or not) based on those decisions.
	☐ The asset owner has described any important external advisors involved in the decision-making process and their incentives.
	☐ The asset owner has explained funded status, operating requirements, or any key pressures or unique circumstances that the organization is facing.
Metrics, Reporting, and Measurement	☐ The asset owner and manager have agreed on the most appropriate benchmark(s), a methodology for assessing long-term performance, and on ways to note differences between the investible universe and the benchmark.
	☐ The asset owner and manager have agreed on key performance indicators (KPIs), along with a methodology to assess progress on investor responsibilities and commitments.
	☐ The manager is able to provide customizable performance reporting solutions that would help de-emphasize short-term performance in favor of evaluating longer-term performance, by using the manager scorecard.
Engagement	☐ The manager reports on stewardship, active ownership, and engagement with portfolio companies, and how these activities have added value relative to the stated investment strategy.
	☐ The manager sets up a process to allow the asset owner to vote their shares instead of electing the manager’s proxy voting policies, in case the asset owner wishes to vote on select shareholder resolutions.
	☐ The asset owner and manager agree on how the relationship will work, including meeting schedules, methods of communication, and conditions for off-cycle reporting.

Trust but Verify

MANAGER SCORECARD

While a meeting schedule is typically agreed at the start of a relationship, the manager scorecard can be completed at any point during the relationship. The scorecard can help focus attention on areas of importance and objectives beyond short-term financial performance.

Manager Scorecard

	Areas of importance and/ or objectives	Exceeds expectations	Meets expectations	Falls short of expectations	Comments
1	Investment performance vs. benchmark				
2	Other investment KPIs (e.g. drawdowns, turnover, style factors)				
3	Portfolio KPIs for client's responsibilities (e.g. net zero)				
4	Active engagement with portfolio companies				
5	Governance and proxy voting				
6	Reputational or organizational issues, surprises, personnel turnover				
7	DEI performance of the manager				
8	Client/manager relationship				
9	Operations (e.g. process efficiency, technology) and compliance				
10	Thought leadership and quality of research				
	Overall level of trust in the relationship				

Examples of Long-Term Mandates

Many institutional investors agree that long-term relationships are more productive, but they struggle to implement and maintain these relationships. FCLTGlobal invited nine global investors—five asset owners and four managers—to meet in Amsterdam in May 2017 to reflect on the terms commonly used in investment contracts. This group grew to seven asset owners and five managers by the time they reconvened in Toronto two months later. The depth of their experience and expertise with mandate strategy and negotiation is unique.

Working groups in 2017 opted not to include the topic of investment risk in the first edition of this document because they felt that it needed dedicated attention. FCLTGlobal undertook a full research project focused just on investment risk in 2018, leading to our publication of Balancing Act: Managing Risk Across Multiple Time Horizons. In May 2019, we convened a working group on translating long-term risk practices into mandate provisions as part of the 2019 Forum on Risk.

Finally, in April and June 2022, we reconvened a working group to integrate investment responsibilities into the model contract provisions, and to expand tools for implementation.

The third edition of this document incorporates this additional member input, and shares close links to Decarbonizing Long-term Portfolios (April 2022), which describes effective mandate design for addressing climate-related investment goals.[9]

Using longer-term investment contract provisions can support asset owners' and managers' stated desire to focus on the long term, and their long-term behavior can translate across the investment value chain to influence corporations' business and capital allocation decisions. Ultimately, a shift toward the long term across the investment value chain can help foster improved economic growth. The group agreed to keep three fundamental constraints in mind throughout the conversations:

- **Institutional investors could typically implement these ideas without regulatory change.**
- **Both asset owners and managers would generally view the terms as in their best interests and therefore be able to agree to them.**
- **Institutional investors beyond our membership would be able to adopt these terms as well.**

Examples of Long-Term Mandates *(continued)*

In addition to incorporating further research and member input on this topic, FCLTGlobal now has the opportunity to publicize the ways in which many of our members have put this research to work. Each of the following examples has occurred in the time since the first publication of this report in 2017.

Australian Future Fund

The Future Fund, Australia's $150.8 billion (USD) sovereign wealth fund, has a mission to strengthen the Australian Government's long-term financial position. The fund has formed strong relationships with external managers and governs these relationships with long-term investment mandates based on transparency and knowledge sharing.

The Future Fund carefully manages investor responsibilities, particularly as they affect its investment strategy. Written into the fund's mandate is the responsibility placed on the board to not "cause any diminution of the Australian Government's reputation in Australian and international financial markets."[11] Any erosion of this reputation or the fund's broader relationship with the government puts its ability to pursue its purpose at risk.

The Future Fund understands that it can deliver on this mandate only when the external managers that invest on its behalf are aligned and behave accordingly. Among other things, this encompasses accounting for the actions and reputations along the investment value chain, including external managers and ultimately the companies and assets held in the portfolio.

Citing FCLTGlobal's original research on long-term mandates, among other sources, the Future Fund documented its responsibilities as an investor and its strategies for fulfilling them. The fund took that information to numerous on-site due-diligence visits with external managers in order to include them in the fulfillment efforts, much like what is described in FCLTGlobal's "Statement of Purpose and Responsibilities for Investors" tool. "Investor responsibility" in this case translates as the reputation the fund enjoys from having fulfilled the priority expectations of its stakeholders.

The Future Fund's dialogue with its external managers improved relationships and alignment on responsibilities. It also strengthened reputation-risk management by building trust and confidence, preventing miscommunication and clarifying expectations around risks. The fund learned that asset owners and managers have rarely engaged in explicit discussion on reputation risk, and greater depth on managing this risk was needed.

The dialogue generated various insights resulting in stronger long-term partnerships between the Future Fund and its partners. It produced key observations on how to enhance reputation risk management, including the following:

- Building a positive organizational culture not only helps reduce reputation risk across stakeholder groups but also explicitly acts upon an important stakeholder group, namely employees.
- Satisfying compliance obligations is a major feature of how organizations protect their reputations.
- Key initiatives include identifying and engaging stakeholders, determining what types of reputation risks matter (i.e., exposure to certain industries, impact of economic sanctions), and understanding the changing landscape of stakeholder and community expectations.
- Beyond relying on firm culture or compliance, strong governance can more formally address reputation risks, highlighting the role that senior executives can play.

- Organizations that experience reputation issues or damage can use the opportunity to make positive changes and build their reputation.

Mirroring the processes described in Ripples of Responsibility: How Long-Term Investors Navigate Uncertainty with Purpose, the Future Fund has used these insights to more fully document, describe, communicate, and fulfill its responsibilities in partnership with external managers. It has strengthened its approach to managing reputation and built sensitivity to reputation risks among its staff.

Going forward, applying the Trust but Verify: Manager Scorecard included in this report could help bring focus to these insights, de-emphasizing short-term performance in favor of criteria that are leading indicators of changes in reputation risk with external managers. For example, organizational culture changes over time as key people and culture carriers depart or join the firm, which could impact future perceptions and risks around reputation. Satisfying compliance obligations is something that is expected, but periodic verification using the scorecard could also help ensure follow-through.

GIC and Schroders[11]

Sustainability is integral to the mandate of Singapore's sovereign wealth fund, GIC, which was established to preserve and enhance the international purchasing power of the country's reserves. The fund believes that companies with strong sustainability practices offer better risk-adjusted returns over the long term, and that this relationship will strengthen over time as market externalities get priced in.[12]

GIC takes a holistic and long-term approach toward sustainability. A critical part of this is to develop the right tools to identify and assess climate risks and opportunities. In general, investors have lacked a framework to systematically assess the opportunities presented by the low-carbon transition, and to determine how these opportunities can be integrated into investment mandates.

To address this gap, GIC and global asset manager Schroders jointly developed a framework to measure and integrate avoided emissions into investment and portfolio analysis. The framework helps highlight companies whose solutions accelerate the low-carbon transition and that might be overlooked by conventional carbon footprint analysis.

The framework identifies 19 carbon-avoiding activities and estimates the emissions savings for each. It then assesses the contribution of different industries in the value chain to these carbon-avoiding activities and quantifies the avoided emission intensity for each industry. By adopting a systematic value-chain approach, the framework captures the contribution of a broad set of industries while minimizing the risk of double counting. The framework derives the emission savings from an individual company based on the firm's revenue exposure to these industries.

The metric can complement conventional carbon analysis and is directly comparable to it. Thus, it offers a common unit of measurement and a more holistic view of both the climate risks and opportunities associated with investment portfolios. Importantly, it doesn't preclude the need for companies to mitigate their Scope 1, 2, and 3 emissions, but could help incentivize the pursuit of more innovative and scalable low-carbon solutions.

By expanding the analysis to the portfolio level, the research also substantiated that companies with positive avoided-emissions exposure experienced 7% annualized revenue growth during a recent three-year period, which is 20% faster than the MSCI All Country Investable Market Index (MSCI ACWI IMI) stock universe. This reinforces the belief that companies contributing to decarbonization of the real economy will deliver better risk-adjusted returns over the long term. Affirming the value and practical application of this framework, Schroders has integrated it into their proprietary tool, SustainEx, which measures a portfolio's overall environmental and social contribution.

Potential areas of further research to enhance the framework include extending it to private markets, increasing the coverage of carbon-avoiding activities, accounting for regional and sectoral differences, and augmenting it with additional non-revenue measures. This will enable the tool to be integrated in investment processes across a broader range of asset classes.

The FCLTGlobal report provides KPIs that can serve as leading indicators for financial performance, providing structures for monitoring portfolio objectives and for fulfilling investor responsibilities. Setting metrics for climate objectives remains challenging and is still a nascent space. Data sets are often incomplete or unavailable. FCLTGlobal's KPIs provide options for investors to monitor performance, and offer an opportunity for discussions between asset owners and managers on how to set objectives and assess performance.

The avoided-emissions framework developed by GIC and Schroders exemplifies how investors can work together to develop novel approaches augmenting traditional carbon metrics and providing a more comprehensive assessment of a portfolio's exposures to climate risks and opportunities.

Kempen Capital Management[13]

Kempen exemplifies how managers can lead the way on long-term mandates, despite often being in a position where clients have their own preferred terms. It has negotiated long-term mandates with clients, and Kempen is the client in other relationships because of its fiduciary management business (e.g., manager-of-managers). The firm looks to apply a long-term perspective across its entire investment business, both directly and via external managers, based on its core philosophy of acting as long-term stewards for clients' capital.

This is evident in several long-term provisions that Kempen routinely uses in its direct relationships with clients:

- **Offering loyalty-related fee reductions so client costs decline the longer a client remains invested.**
- **Emphasizing longer-term performance first in reporting to clients.**
- **Communicating very clearly with clients about how the firm has voted their shareholdings in individual companies through a custom proxy voting portal.**

Being a €70+ billion (EUR) allocator on behalf of its clients is an advantage and helps Kempen to shape submanager terms: fees, structure, and approach to stewardship and sustainability.

Managers sometimes can be reluctant to try new fee arrangements, but Kempen has found a good bit of success in this area. For instance, Kempen has benefitted in several instances from the same sort of loyalty discount that it offers to clients, in which fees step down over a multi-year period. There also have been instances in which Kempen invested in a founders' class whose fees step down as the AUM reaches certain thresholds. In effect, this is another way of being rewarded for longevity.

Examples of Long-Term Mandates *(continued)*

Finally, in some less-liquid funds, the performance fees that Kempen pays are backdated. The manager realizes those fees in line with the liquidity cycle of the fund.

Kempen then looks for evidence of a long-term focus in the structure of its relationship with external managers. The firm's research team will approve managers only at the end of an extensive research process, including attention to turnover in the portfolio. Kempen believes that turnover should be very low: 5-10% annually is not uncommon since the general expectation is to hold shares for 7 to 10 years. This relationship-building assessment also involves Kempen sharing its beliefs with submanagers about avoiding investments in cluster munitions and tobacco. Mandate structure will clearly vary according to asset class, but Kempen maintains the broader principle of acting as a long-term steward in all of them.

Stewardship and sustainability also are essential to Kempen, and this is evident in part from the active ownership and engagement practices that it expects from sub-managers. Long-term shareholders often outlast individual executives, or even several cycles of executives. Part of this dialogue between the sub-manager and the company is about impressing a solid ESG awareness on companies' management teams, in particular noting how an ESG misstep compromises license to operate. Reciprocally, Kempen expects sub-managers to know the companies in which they invest and to invest in high quality companies: those with a healthy balance sheet, solid management, and understandable business model.

Kempen has a lengthy history of using mandate provisions broadly for their long-term effect. A more recent precedent involves Kempen introducing the large-cap European Sustainable Value Creation strategy in 2017, co-created with one of the firm's larger fiduciary pension fund clients.

This Dutch industry-wide pension fund sought to invest specifically in relation to select UN Sustainable Development Goal (SDG) impacts but was unable to find an existing product of this type. Kempen engaged to develop a global impact strategy that drew on its in-house expertise in responsible investment, private markets manager research, portfolio management, and product design. Kempen agreed to a fee discount in exchange for the client's support creating the strategy, and the client agreed because they were looking for the sort of low-cost, ESG-integrated equity strategy in which Kempen specializes.

Experiences like this remind Kempen that it's all about aligning with the client's objectives. The individual mandate terms are part of a broader toolkit, some parts of which will be relevant depending on the client, their objectives, and the characteristics of the asset class—others less so. Kempen finds packages that work for all parties in the various ways that it combines long-term mandate provisions. Clients clearly value the overall package for the alignment of interest and time horizon that it creates and for the understanding of investment objectives from the outset.

MFS Investment Management[14]

MFS equally exemplifies how managers can lead on long-term mandates. Establishing a long-term frame in how it reports performance is a priority for the firm. One of its easiest but most significant shifts in reporting performance to its independent mutual funds board was changing the order of the timelines, which in turn helps to focus discussion on longer-term numbers. Instead of beginning with year-to-date, one-, three-, five- and 10-year figures, MFS now begins with the 10-year figure and has dropped the year-to-date altogether. It also has stopped highlighting the three-year figure, which makes a significant visual impact.

In addition, MFS now sorts the numbers and rankings by the five-year figure. The former approach perpetuated a focus on short-term results, while the latter shifts the focus to a more relevant long-term performance view, creating better-aligned conversations from the start with each portfolio manager.

This is the behavioral “framing effect” at work again. The reference point at the start of a conversation frames everything that follows. Having a performance review focused on the long term is very difficult when the first bit of information is a year-to-date return. That sort of performance review is easier when the first bit of information is a 10-year return.

MFS didn’t stop here, though. The benchmark for an investment also is part of the reference frame, and MFS has honed the way in which it explains the selection and function of benchmarks. FCLTGlobal learned in the first edition of this mandate research that “how the benchmark is used and its reference time frame are more important than selecting a specific benchmark,” and MFS’ real-world experience gives life to this finding.

Choosing the types of performance to measure also is very important. MFS looked for a metric that could assess its stated investment philosophy and process, and stock turnover is one of the foremost metrics that it chose. Turnover data shows evidence of the firm’s process and conviction, with the longer-term outcomes of end-investors. Members of FCLTGlobal’s 2017 working group expected that this would be the case and envisioned turnover as a KPI for a long-term mandate agreement.

Adjusting mandate agreements in these ways may seem insignificant, but it’s not. There’s a potential for results that are outsized—but not necessarily easy to achieve. MFS had internal challenges. It took more time than expected to build an understanding with the board and ensure that efforts were not viewed as self-serving. However, it has been worth all the effort.

New Zealand Superannuation Fund

Precedents set by the New Zealand (NZ) Super Fund, a $42 billion (USD) asset owner, are framed by the special responsibilities that come with being a sovereign wealth fund.

Ahead of specific mandate design, NZ Super Fund identifies managers that align well with the fund's purpose and approach, then prioritizes those that can deliver on the target strategy with a suitable risk/reward profile. Trust is built during this due-diligence process, ideally laying the foundation for an authentic, transparent, long-term relationship. The fund discounts managers that bend their strategy or change their core objectives solely to win business. Experience has demonstrated that such fundamental misalignments can lead to poorer outcomes. It does so by assessing the manager's interactions with other stakeholders—from regulators to their own employees, and with other clients. For example, one objective is to look at how well the manager follows through on its diversity, equity, and inclusion beliefs in its engagements with portfolio companies, in addition to its own employees.

The function of a long-term mandate then is to formalize the quality and character of that transparent relationship. One important way managers provide transparency and strengthen relationships is through sharing knowledge. The fund develops insights into the manager's thinking and processes which serve as valuable context when evaluating performance. From there, the manager develops insights into the fund's risk appetite, decision processes, and any factors that collectively characterize it as a New Zealand sovereign wealth fund. Together these elements ultimately lead to more stable investment management relationships and fewer pivots due to shorter-term exigencies.

"What you are looking for is evidence that the manager actually understands you and your context, in our case as a government-owned sovereign investor with particular responsibilities," notes NZ Super Fund Manager of External Investments Rishab Sethi. "We have certain transparency requirements ourselves."

By contrast, NZ Super Fund expects the long-term effect of fee arrangements to do no harm. Short-term fee arrangements will produce short-term behavior. A preferred fee arrangement for NZ Super Fund is one that permits the long-term effects of other provisions to materialize without interference. The fund believes that circumstances—asset class, investment strategy, hurdle rate, manager type, and others—determine which of these other provisions will prompt longer-term focus and, consequently, that the fee arrangements that complement this focus are also variable. NZ Super Fund prefers this case-by-case discretion to a rule-bound mode of thinking about fees.

A good relationship extends beyond a mandate's contract provisions, essentially embodying a partnership. For instance, NZ Super Fund participates in club deals and co-investment opportunities with other like-minded asset owners. This can build scale in investments like real estate or infrastructure. NZ Super Fund often works with a manager to put together a private structure that works for all investors. A manager finds it beneficial when they can expect high commitment and trust from investors, making club deals attractive from a product offering and business standpoint.

To NZ Super Fund, mandates are a necessary but not sufficient tool for fostering long-term focus in a relationship with a manager. Mandate provisions formalize relationships that are in a position to succeed, but it is due diligence—not mandate provisions—that allow relationships to produce strong returns and to satisfy important responsibilities. The hardest work is done in due diligence, and then a long-term mandate agreement confirms that the manager has the fund's interests in mind and outlines the framework for following through.

Examples of Long-Term Mandates *(continued)*

Ontario Teachers' Pension Plan[15]

Asset owners like OTPP, which manages $201.4 billion on behalf of 327,000 working and retired teachers in the province, are especially important when it comes to setting long-lasting precedents and starting mandate negotiations on their own terms.

Large asset owners always have standard investment management agreements (IMAs) to provide this framing (also called preferred terms, form/template IMA). OTPP has integrated many specifically long-term provisions into its standard long-only equity IMA:

- **Compensate using longer-term fee arrangements, such as longevity discounts or longer-term performance measurement.**
- **Report long-term performance before short-term performance in all tables, per a visual exhibit that OTPP created.**
- **Focus prose commentary on year-to-date performance instead of monthly or quarterly.**
- **Disclose managers' active-ownership strategies (where applicable); and**
- **Treat succession planning, succession events and investment capacity planning as leading indicators of performance and disclose accordingly.**

OTPP accounts for a tendency that all people share, which behavioral scientists call the "framing effect," by including these long-term provisions in the standard IMA. The framing effect describes how the reference point at the start of a relationship frames everything that follows. For instance, having an investment relationship focused on the long term is very difficult when short-term information gets the spotlight and the strategy depends entirely on just a few key people. That sort of relationship is easier when the first bit of information in performance reports covers a long horizon and when institutions are transparent about how their relationship can last beyond the individual people who are involved today.

The standard IMA of an asset owner—a client—is the firmest frame that exists in mandate negotiations, and framing those negotiations with long-term provisions is the most systemic way in which an asset owner can use its mandates to increase focus on the long term. OTPP is doing exactly this in all of its new long-only equity mandates and also gradually integrating these same provisions into existing agreements.

This work began with pilots that OTPP conducted, starting in early 2018. OTPP's initial allocation was $200 million (CDN) to an emerging manager. This relationship offers OTPP access to new investment opportunities, the manager gets stability while establishing the business, and both enjoyed a chance to start fresh on the mandate provisions. OTPP and the manager used this opportunity deliberately by piloting provisions to report long-term performance first, discounting the management fee based on the length of the relationship, incorporating a declining fee for no-cause termination, and disclosing information about active ownership practices.

OTPP's experience implementing this pilot was positive, so it increased funding to mandates using terms like these to $500 million over the course of a year, and additional funding took the value to $700 million by the end of 2019. Four mandates use these more extensive long-term provisions, including several that also measure performance fees on a multi-year horizon, and others are under negotiation. One of the biggest benefits has been reducing costs: the decision to include longevity discounts in their mandate provisions will reduce OTPP's long-term projected management fee expenses.

Examples of Long-Term Mandates *(continued)*

Still, OTPP's successful implementation of long-term mandate provisions has not come without challenges. Efforts to negotiate longevity discounts have been mixed, and operational inertia creates resistance from managers to reversing the order of performance reporting. Some have pushed back on the term because it requires them to change their code for generating performance reports, but many backed down when OTPP has insisted on the grounds of investment strategy.

Wellington Management

Wellington Management demonstrates how an asset manager can support effective communication, objective setting, and management of client expectations in investment mandates. Major additions to the third edition of this investment mandates report include tools to accomplish these goals. These tools promote successful relationships by enhancing transparency through the Aligning Expectations for Long-Term Success: Onboarding Checklist and the Statement of Purpose and Responsibilities for Investors, and by using the Trust but Verify: Manager Scorecard to maintain relationships.

In Wellington's case, the focus is on establishing a service-level agreement, such as a memorandum of understanding (MoU). This strategic tool seeks to achieve alignment on important objectives for the relationship between the asset owner and manager. It strongly resonates with the approach provided in FCLTGlobal's toolkit.

Wellington has found that to maximize the chances of a successful long-term relationship, it is important to establish clear qualitative and quantitative expectations at the outset and to review them on an ongoing basis. Using an MoU is one way to do this, helping early on to establish expectations that serve as a reference point for future evaluations.

While the nature and scope of each client relationship are unique, Wellington describes certain factors for successful relationships over the long term, including:

- Agreement, from the beginning of the process, on clearly articulated long-term investment goals
- Agreement on how success will be measured against the goals, including on a qualitative (e.g., regular engagement and transparency) and quantitative (e.g., pricing, capacity, and KPIs) level
- Regular communication across multiple touch points on both sides of the relationship, including across various areas of expertise (i.e., portfolio management, risk management, senior management, and operations)

These factors help set the relationship's character from the outset, avoiding unwanted surprises. They also provide the space for Wellington to meet client objectives by leveraging the firm's skills. Developing this understanding and coordinating communication over what can potentially be decades helps build trust, increase transparency, and enhance the overall relationship between the asset owner and manager.

While Wellington's MoUs are typically bespoke and adaptable to specific client circumstances, an MoU may generally cover the following areas: goals and expectations, the scope of the relationship,

Examples of Long-Term Mandates *(continued)*

key contacts, risk and return parameters, investor responsibilities, confidentiality, and the relationship review and feedback process.

While an MoU can help fulfill client objectives, successful client relationships are not solely driven by written agreements. From Wellington's point of view, the all-important element seems to be a deep and abiding sense of trust between two organizations, which can only be developed over time and many interactions.

Wellington has found that the strongest client relationships are built on a high degree of transparency, a long time horizon for evaluation, multiple touch points, and a fair degree of cultural alignment. An MoU is one piece in the process of designing investment mandates that Wellington uses to help orient relationships toward long-term goals and establish stable, lasting partnerships with a deep mutual respect for the challenges and objectives facing each organization.

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Endnotes

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