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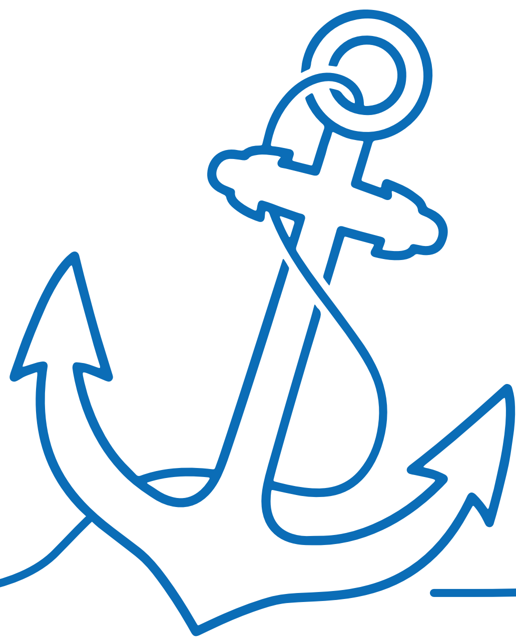

REPORT

Institutional Investment Mandates

ANCHORS FOR LONG-TERM PERFORMANCE

SECOND EDITION

FCLTGLOBAL

APRIL 2020

FCLTGlobal is dedicated to rebalancing investment and business decision-making towards the long-term objectives of funding economic growth and creating future savings.

FCLTGlobal is a not-for-profit dedicated to developing practical tools and approaches that encourage long-term behaviors in business and investment decision-making. It takes an active and market-based approach to achieve its goals. By conducting research and convening business leaders, FCLTGlobal develops tools and generates awareness of ways in which a longer-term focus can increase innovation, and create value. FCLTGlobal was founded in 2016 by BlackRock, Canada Pension Plan Investment Board, The Dow Chemical Company, McKinsey & Company, and Tata Sons out of the Focusing Capital on the Long Term initiative. Its membership encompasses asset owners, asset managers and corporations from around the world.

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Executive Summary

Asset owners—the cornerstones of the investment ecosystem—often have very long-term investment goals, such as funding liabilities, building an endowment for perpetuity, or providing for subsequent generations. For some of these asset owners, especially pension and retirement funds, these goals reflect the long-term needs of individual plan members who rely on these institutions to safeguard and build the savings which they will need down the road. Ensuring assets are managed in line with these long-term horizons is critical to achieving these goals. This presents a challenge, however, because assets are often managed by asset managers, distinct from the asset owners, and managers may have different time horizons, incentives, and goals.

Among the most important elements in ensuring that institutional investor partnerships fulfill long-term objectives are the investment management contracts between asset owners and asset managers, the "mandates." The terms and conditions embodied in these mandates constitute a mutual mechanism to align the asset managers' behaviors with the asset owners' objectives. These contracts define the relationships between asset owners and asset managers and play a crucial role in ensuring the success of these relationships over time.

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.

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 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? Disclosure of changes in the firm or team, shifts in the investment process, and results measured by key performance indicators (KPIs) may provide an owner with more insight into future performance than current or past performance does.**

- **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 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.**

This paper provides a starting point for contract negotiations between asset owners and asset managers, helping them define mandate terms that build trust, ensure alignment, and advance the owners' long-term investment goals.

Institutional Investment Mandates: Anchors for Long-Term Performance

The relationship between asset owners and asset managers presents a classic time-horizon mismatch. The owner has a specific set of investment objectives that correspond to its stakeholders, liabilities, return goals, and risk tolerance. The manager has a different set of stakeholders; 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. Nearly a thousand investment professionals surveyed by State Street's Center for Applied Research affirmed this challenge: "77 percent of asset owners said they were concerned that short-term incentives were not being aligned with long term objectives… More than half of asset managers (57%) said the same." Institutional investors' best tool in accomplishing this difficult goal is the investment mandate, the contract that governs these relationships and lays out the specific terms and parameters of their relationships.

FCLTGlobal's long-term model for institutional investment mandates responds to this challenge by providing a menu of ideas to help anchor these mandates to the long term. The asset owners and asset managers involved in the 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 asset managers' behaviors with the objectives of the asset owner, not simply a legal contract." This project 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. Indeed, adapting mandate agreements is an important and readily-available action for the 82 percent of asset owners and managers who told State Street about their concern with short-term relationship impediments and who also admit that nothing is happening in response.

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 asset managers. Quarterly performance is an easy measuring stick to use, but it 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, leading to a deeper understanding of the managers' strengths and weaknesses, and improving the likelihood of successful investment outcomes. 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—particularly 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.

Top Ten List for Long-Term Mandates

The terms and conditions that asset managers and asset owners set for their relationship can drive long-term or short-term behavior. Based on a series of working groups with leading asset owners and asset managers from around the world, we offer this list of questions to anchor 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 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 asset 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 asset gathering 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 time frames 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 casting proxy votes strategically.

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 come together in a coherent way, so that the contract terms are complementary and supportive of long-term investing. Above all, do the terms enable the manager to commit capital according to the desired time frame of the strategy, or is there some mismatch in incentives, liquidity, or elsewhere?

Model for Long-Term Contract Provisions

In the first matrix that follows, 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.

In the second matrix, we rethink the KPIs that asset owners use to evaluate asset 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 investors better leading indicators of performance than backward-looking returns do.

Long-term investors select mandate provisions and KPIs appropriate for the specific investment approach and relationship. 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.

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

Asset managers who use 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 for them. An owner receives a benefit for patience and continuing commitment, while the manager benefits from the comfort of a more reliable capital base, both of which may help them capture long-term premia.

Owners and managers that 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. We 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. 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 asset 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 asset manager continues to act in the best interests of the asset owner—may build the relationship with a long-term time frame in mind, 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 lock-ups, 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 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**. It is tempting for managers to grow assets in high-performing strategies beyond the level at which they can expect to 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 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 events of the quarter—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, 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.

In order to thrive in the long term, investors also have to 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. Owners and managers may find it easier to maintain relationships for longer 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, 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.

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 avoid 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 investment performance. The mandate can provide a framework for 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 owner for three years after termination counteract owners' tendency to terminate managers after poor performance only to have performance rebound as it reverts to the mean?**
- **Would alternate 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?**
- **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 asset 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?**

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 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. The second edition of this document incorporates this additional research and member input.

Our purpose in convening this working group and developing this paper has been to re-anchor the status quo from contract provisions that favor the short term to provisions that support and encourage long-term investment behavior.

Using longer-term investment contract provisions can support asset owners' and asset 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 ideas in mind throughout the conversations:

- **Institutional investors could typically implement these ideas without regulatory change.**
- **Both 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.**

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 come to pass in the time since the publication of this report in 2017.

Ontario Teachers' Pension Plan[1]

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.

Ontario Teachers' and other asset owners are the clients in their relationships with asset managers, and they are empowered to start 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 $500m over the course of a year, and additional funding took the value to $700m 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.

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.

Kempen Capital Management[2]

Kempen exemplifies ways that asset managers can lead the way on long-term mandates, despite often being in a position of clients having 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 all of its 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 that client costs decline the longer that 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 €70bn+ allocator on behalf of its clients is an advantage and helps Kempen to shape sub-manager 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. 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 sub-managers about avoiding investments in cluster munitions and tobacco. Structuring of a mandate clearly will 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 mis-step compromises your 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 selected 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[3]

MFS equally exemplifies ways that asset managers can lead the way on long-term mandates. Establishing a long-term frame in the way that 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 make 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 key performance indicator 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 our efforts were not viewed as self-serving. However, it has been worth all the effort.

Adjusting Performance Reporting[4]

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[5]:

> *...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.[6] CalSTRS focuses trustees' discussion on the long-term, rather than the most recent quarter, by beginning the report with 10-year performance. This accommodates CalSTS' 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.

Brazilian asset manager Neo Investimentos also implemented this reverse order when reporting their performance to all their clients about one year 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 long-term investment approach is now better understood by our audience, in a very simple and straightforward way" he said.*

Conclusion

Long-term asset owners and asset managers already have used these ideas 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 towards 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 parameters of the investment relationship and defines 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, 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.

Long-Term Model for Institutional Investment Mandates:

Contract Provisions

	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 claw backs • 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
Benchmark	• Cap-weighted reference index	• Cap-weighted or custom reference index, as appropriate	• 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 LIBOR+/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 • Lock-ups 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
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
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)
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 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 hyperlink)
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 Indicator 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	• 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

In addition to monitoring performance, long-term asset owners monitor the way that asset managers manage portfolios and their businesses. Specifying KPIs that may be leading indicators of performance can provide structure for that monitoring. Institutional investors select among these disclosure terms based on their investment strategy and are unlikely to use all of them in one mandate.

KPI	DESCRIPTION	KPIs COULD INCLUDE	
Portfolio	Stating investment beliefs 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 • Turnover • Drawdowns • Leverage ratios • Active Share	
Business and Personnel	Evaluating an asset 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) • 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 asset 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	

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 governance, etc.)	*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	

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