FOCUSING CAPITAL
on the LONG TERM

LONG-TERM PORTFOLIO GUIDE

Reorienting portfolio strategies and investment management to focus capital on the long term

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

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Contents

Introduction 4

Guiding principles 6

Investment beliefs 8

Risk appetite statement 16

Benchmarking process 21

Evaluations and incentives 27

Investment mandates 34

Conclusion 45

Appendix 46

Acknowledgments 48

Notes and References 49

Introduction

Since the 2008 financial crisis, there has been plenty of discussion about the perils of short-termism, but concerted action to remedy them is lagging.[1] In "Focusing Capital on the Long Term," a *Harvard Business Review* article published in January 2014, Dominic Barton of McKinsey & Company and Mark Wiseman of the Canada Pension Plan Investment Board argue that "the single most realistic and effective way to move forward is to change the investment strategies and approaches of the players who form the cornerstone of our capitalist system: the big asset owners…Action must start with [them]. If they adopt investment strategies aimed at maximizing long-term results, then other key players—asset managers, corporate boards, and company executives—will likely follow suit".[2]

In a recent survey of public and private pension plans and sovereign-wealth fund managers, respondents overwhelmingly agreed that while the ability to invest long term is an advantage, they do not necessarily have an effective set of implementation strategies/tools to help them realize their aspirations to be long term.[3]

To address this lack of long-term tools for institutional investors (that is, asset owners, including pension funds, sovereign wealth-funds, mutual and other investment funds, and life insurance companies; and asset managers, including investment-management firms and internal portfolio managers at asset owners),[4] FCLT brought together more than 20 experienced investment professionals from nine institutional-investment organizations controlling an aggregate of over $6 trillion in assets under management. Our goal was to develop practical ideas for how institutional investors might reorient their portfolio strategies and management practices to emphasize long-term value creation and, by doing so, be a powerful force promoting a long-term mind-set throughout the investment value chain (see Appendix A).

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

Five core action areas for institutional investors	Institutional investors should…
1 Investment beliefs Set the investment philosophy, and provide a compass to select investment strategies and navigate short-term turbulence	**Clearly articulate investment beliefs, with a focus on their portfolio consequences, to provide a foundation for a sustained long-term investment strategy.**
2 Risk appetite statement Establishes the risk framework by clarifying the asset owner's willingness and ability to prudently take risks and accept uncertainties	**Develop a comprehensive statement of key risks, risk appetite and risk measures, appropriate to the organization and oriented to the long term.**
3 Benchmarking process Measures the success of investment strategies and their execution over the long term	**Select and construct benchmarks focused on long-term value creation; distinguish between assessing the strategy itself and evaluating the asset managers' execution of it.**
4 Evaluations and incentives Ensure alignment between asset owner's and asset manager's financial interests towards the long term	**Evaluate internal and external asset managers with an emphasis on process, behaviors and consistency with long-term expectations. Formulate incentive compensation with a greater weight on long-term performance.**
5 Investment mandates Define and formalize the portfolio approach, and the relationship between asset owner and asset manager	**Use investment-strategy mandates not simply as a legal contract but as a mutual mechanism to align the asset managers' behaviors with the objectives of the asset owner.**

A discussion of each action area follows in this paper. We address the management of institutional-investment portfolios and mutual funds, with particular focus on public equities. Investments in publicly-traded equities and bonds are the single biggest component in the collective portfolio of institutional investors and many public companies continue to exhibit excessive short-termism, which is often reinforced rather than countered by the behavior of many institutional investors.[5] However, some of the ideas we present in this paper can be applied more broadly to the total portfolio.

Given the need for action, we focus on areas where asset owners and managers have the ability to act immediately and change practices on their own initiative. However, there is only so much they can do by themselves. Broader issues of regulation and governance of institutional investors must continue to be addressed.[6] While beyond the scope of this paper, our views can be summarized as follows:

- Regulators and policy-makers need to strike a better balance between their current emphasis on setting short-term accounting rules, funding requirements and required reserves for prudential purposes, versus enabling the pursuit of long-term investment strategies that are appropriate to long-term liabilities. For example, given the volatility of capital markets, rigid annual mark-to-market requirements for pension plan assets and liabilities can hinder optimal management of the fund for the long term.
- Institutions seeking to pursue true long-term investment strategies must first be founded on governance structures that support, even force, an attention to the long term. Such structures should ensure effective direction and oversight of the investment process through sufficiently qualified boards with relevant experience, possibly including members who represent beneficiaries, and should provide the board and management the freedom to act in the long-term interest of their beneficiaries. Governance, like regulation, is highly sensitive to context. Core governance issues (for example, board composition, reporting, and transparency requirements) are inevitably impacted by institutional purpose, ownership structures, legislation and many other factors. While there is no such thing as a universal prescription for sound long-term governance, there are many examples today of models that work. For example, the governance structures and practices of the top ten Canadian pension funds are often cited as a major competitive advantage allowing them to invest for the long term.[7] Key principles of integrity, clear purpose and accountability should run through all well-governed organizations.

This paper is written by investors, for investors.[8] A diverse group of institutional investors and investment professionals helped contribute to this paper and each may hold the ideas expressed to varying degrees. Within the context of their own unique situations, we encourage institutional investors to evaluate, adapt, and adopt an organizationally appropriate mix of these ideas to enhance the long-term value they create for their beneficiaries.

Guiding principles

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

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

We define long-term investors as stewards of capital who have the ability and willingness to invest in businesses to create and grow value on a sustainable basis for their stakeholders.[9]

Long-term investing...

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

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

Guiding principles for investors to focus on the long term:

Align stakeholders and minimize agency costs

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

Focus on intrinsic value of assets and long-term real value creation

- Invest rather than speculate—build and manage the portfolio as business owners who invest capital where it will grow rather than unduly focusing on a benchmark.
- Assess a company's fundamentals and ability to generate long-term real value based on the relative lifetime of the underlying business assets.

- Use current market pricing primarily to determine margin of safety versus the intrinsic value of the underlying business and thus the timing and sizing of investment.
- Give appropriate weight to inherently long-term factors, including the long-term implications of environmental, social, and governance (ESG) risks and opportunities.

Develop and execute robust, sustainable investment processes

- Allow and encourage portfolio management to remain focused, patient, and disciplined.
- Create and use the ability to be countercyclical.
- Stay the course during market cycles and turbulence, yet adapt to secular evolution.
- Help build trust and partnership between asset owners and asset managers.

Positively influence the management of investee companies

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

1 Investment beliefs

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

Are markets very, somewhat or not at all efficient? Is alpha fleeting or persistent, rare or common, predictable or unexpected? What can passive and active investment strategies deliver over the long term? How important is the initial asset allocation relative to investment selection and strategic shifts? How much diversification is "enough" in markets that are imperfect? Can we trace and profit from patterns in the deviation of market prices from "fundamental" or "intrinsic" value? What exploitable advantages do long-term investors have? What type of relationships between providers, managers and recipients of capital lead to better long-term returns?

Every investor, regardless of size or structure, must address these and many other similar questions. The answers are essential to identifying and sustaining institutionally appropriate investment strategies. When it comes to financial markets, there are few universally acknowledged truths. As a result, institutional investors must often rely on incomplete evidence from particular places and times. They must use both deductive and inductive reasoning[10] and look deep within to understand their own appetite for risk, their behavioral biases, and other factors that might influence their investment decisions.

Investment beliefs are tenets and principles based both on conviction and fact. They set the investment philosophy, provide a long-term compass to select investment strategies, and help navigate short-term turbulence. Used wisely and consistently, investment beliefs are sturdy anchors for decision-making at every level.

Six reasons to hold (formal or informal) investment beliefs[11]

1. **Investment beliefs offer a consistent way of thinking about financial markets and how they work.**
Our understanding of how financial markets work will always be incomplete. Our knowledge also suffers from a low signal-to-noise ratio: the ratio of expected return to risk is low and variable.[12] Nonetheless, research over the years has uncovered several likely truths—some more likely than others—about the nature of the markets. As investors, we must decide which of these "likely truths" we choose to believe in, and equally important, how we use them to guide our investment approach. For long-term investors especially, coming to terms with the mystery of markets and developing a consistent way to think about them is essential to being able to sustain their investment strategies.

2. **Investment beliefs help investors define a sound investment process that is relevant to their circumstances.**
Rigorous processes ensure consistency and discipline in investment strategy, even as an organization undergoes change and market conditions fluctuate. Holding well-understood investment beliefs leads to reduced costs of decision-making, as it becomes easier for investors to accept propositions that are consistent with those beliefs and to disregard those that are not. It provides continuity, ensuring that institutionally agreed-upon views remain the definitive guide to investment decisions; this should hold true even in the face of staff changes, as new experiences and perspectives are assimilated by the organization. While rigor does not mean rigidity, and strategies and processes must adapt to changing long-term realities, the clear articulation of investment beliefs establishes the burden of proof for change (for example, the required maturity of new ideas) at the outset, providing certainty and clarity for all decision-makers.

3. **Investment beliefs encourage long-term investors to look past short-term market prices and focus on long-term fundamentals.**
Long-term investors seek to establish the long-term intrinsic value of a security in order to buy at or below this value. Future market prices are the result, not the driver, of company fundamentals. Investment beliefs encourage decision-makers to ask the right questions and look at the right factors that are truly material to long-term value creation.

4. **Translating beliefs consistently into processes and practices helps investors combat behavioral biases that distort rational decision-making.**
   The existence of behavioral biases is widespread and critical to decision-making. Beliefs can help "stay the course" and help counteract the effects of pre-existing biases. In the absence of clear, strongly held convictions, investors are liable to drift from one strategy to another, with the result being "excessive transaction costs ... and the high chance of incurring losses from chasing the next best thing."[14]

5. **Clear and consistent investment beliefs can also help mitigate principal-agent problems.**
   Principal-agent problems[15] arise from the fact that the incentives of an asset management firm may be different or even contrary to the interests of its clients. Beliefs that acknowledge the inevitable existence of these problems can then be used to construct incentives and processes that counter them.

6. **Investment beliefs are an indispensable communications device.**
   Well-substantiated beliefs can help articulate and justify a long-term investment strategy and establish a long term-focused culture. For this reason, beliefs are best framed in plain language that makes them accessible to all, including trustees, beneficiaries and the public. Specialized investment strategies are easier to explain when reference is made to a consistent subset of related institutional beliefs that have been previously examined and adopted.

Idea in action:
Using investment beliefs to inform investment strategy

The New Zealand Superannuation Fund (NZSF), a New Zealand government entity established to pre-fund future pension liabilities, developed an investment strategy ("strategic tilting") predicated on two investment beliefs (each of which is grounded in investment fact but not necessarily definitively proven):[16] First, asset classes returns are partly predictable. Over time, returns tend to revert toward a mean. Second, investors with a long-term horizon can outperform more short-term focused investors over the long run.[17]

"Strategic tilting" is a technique that NZSF uses to add value to its reference portfolio (that is, NZSF's definition of a low-cost, easily accessible benchmark). The technique involves "dynamically adjusting the long-run risk profile embodied in NZSF's reference portfolio" by adjusting/tilting broad listed asset class holdings relative to their weights in the reference portfolio according to their relative expected returns over near- and medium-term horizons. However, the signals are not followed automatically and a substantial judgmental overlay is applied.

Since strategic tilting is a "contrarian" strategy that can result in extended losses relative to long-run benchmarks, NZSF could underweight an asset class in a bull market or overweight it in a bear market—situations which, if persisting, could create enormous pressure to unwind the strategy. Thus it is imperative that NZSF's board is strongly committed to the strategy, sticking to the investment beliefs behind it and willing to defend it to internal and external stakeholders, particularly in periods when the strategy underperforms. In order to ensure staff alignment, staff compensation and incentives are independent of the performance of the tilting program and are based on the performance of the overall portfolio relative to the benchmark, with tilting being only one component in the construction of this portfolio.

To articulate, or rearticulate, investment beliefs to reflect long-term orientation and intentions, institutional investors should:

- Involve and ensure the commitment of all major internal stakeholders (board members, senior leadership and all levels of the portfolio-management team) in the formulation process to develop a set of investment beliefs that will be universally adhered to by employees, management and the board.
- Examine and record why they hold particular beliefs, and analyze their practical implications.
- Determine if their beliefs provide a valuable long-term compass to guide their selection of investment strategies and to navigate short-term turbulence.
- Consistently check to ensure investment beliefs are reflected in the investment process. As the global economy and capital markets evolve, even the most firmly held investment beliefs should be reviewed from time to time. And if their underlying philosophy and rationale are sufficiently well-grounded, the evolution of beliefs and portfolio consequences will be progressive and incremental rather than reactive and disruptive.[18]

Idea in action: Developing investment beliefs for the long term[19]

The Dutch pension fund *Pensioenfonds voor Zorg en Welzijn (PFZW)* reformulated its investment beliefs in the aftermath of the global financial crisis. In particular, PFZW staff started questioning whether the efficient markets paradigm remained relevant to their investing strategy. The crisis also prompted questions about the social sustainability of the plan, not just its financial soundness. For example, one core question at PFZW became: "Being a large asset owner with a long horizon, should PFZW not contribute to the economic and social well-being of society instead of merely being agnostic to them?"

Meanwhile, the separation of investment strategy and administration between PFZW and PGGM, its pensions and investment management services organization provided an opportune time to revisit beliefs – until 2008, PFZW and PGGM were one organization. The main characteristics of the reformulation process were:

- Substantial and early input from the board of directors.
- The identification of key questions and their classification under three areas – "How can we invest in a way that (1) is suited to the financial ambitions of our plan participants, (2) fully integrates sustainability, and (3) is intelligible and controllable?" Relevant literature was collected and assessed, experts were interviewed, board members were surveyed to reveal their preferences over risk and return, and contrarian thinking was embraced.
- The resulting investment framework emphasizes parsimony and flexibility, and provides important support for negotiating uncertainty – attributes all revealed to be highly desired by the staff undertaking the formulation exercise.

Whether or not they are formally adopted or even stated, investment beliefs form the foundation of all investment strategies and decisions. Since the answers to fundamental investment questions often cannot be grounded definitively in fact and necessarily differ from one investor to another depending on circumstances, we call them beliefs. By definition, beliefs cannot always be substantiated with unequivocal evidence[20] and they are collective judgments based on academic literature, research, and experience.

Below, we provide a small selection of beliefs, together with some justification for holding them, which a long-term investor could adopt and adapt. In surveying institutional investors, an appreciably wide range of beliefs exists. As previously noted, each institution should identify a set that is most pertinent to their investment purpose and method.

A selection of investment beliefs that a long-term investor may wish to adopt and adapt:

1. **Long-term investors should focus on the fundamental drivers that affect the underlying value of a business.**

   Long-term investors care about returns over the often open-ended lifespan of a fund, usually existing to meet distant time-weighted liabilities. Returns over the long term are a product of fundamental economic drivers (and therefore of fundamental values), as any short-term deviations that cause short-term price fluctuations will eventually be arbitraged away, as expectations are replaced by realities. For any given investor, the intrinsic value of a security reflects its fundamental value, approximated by the cash flows generated by that security over its lifetime, discounted by the opportunity cost of that investor.

2. **Market prices deviate significantly from fundamental or intrinsic value in the short run.**

   Market prices can deviate from fundamental values for many reasons. Market failures often occur due to asymmetric and incomplete information. Behavioral biases such as herding and myopic loss-aversion[21] can cause investors to temporarily ignore "rational" pricing in favor of heuristics or the "wisdom" of crowds, especially as processing information carries substantial costs. As a result, prices can over- or undershoot intrinsic values for sustained periods of time. In the long run, however, more fundamental forces such as firm-specific or economy-wide productivity subsume these localized effects.[22]

3. **Market returns show short-term momentum but longer-term tendency for reversion to the mean. Markets price short-term news more fully and accurately than long-term trends.**

   Many studies have found evidence of negative serial correlation—that is, return reversals—over longer holding periods.[23] While there is support for long-run negative serial correlation of stock returns at higher frequencies, there is limited data available on long-horizon returns; therefore the statistical power of inferences such as those drawn by Poterba and Summers (1988) has been questioned. Further, the finding of mean reversion varies across studies and time periods—the strongest evidence comes from time spans that include the Great Depression. However, mean reversion over long time horizons is supported by structural models, such as that of Campbell and Viceira (2005).[24]

4. **Long-term investment strategies must be more concerned with long-term risk of loss than short-term volatility.**

   This investment belief provides guidance on the construction of an appropriate risk appetite statement (discussed in the *risk appetite statement* section). Essentially, it relates to reorienting the risk profile of the long-term investor such that focus is on avoiding the permanent impairment of capital (or another definition of long-term risk appropriate to the investor), and thereby surviving short-term pressures on investment strategies. In the long term, a focus on avoiding non-recoverable loss delivers the best possible chance of weathering volatility.

5. **Diversification is essential, but only if it is applied across truly diverse long-term fundamental factors.**

   Modern portfolio theory contends that portfolio risk can be lowered by holding multiple assets. In this way, the idiosyncratic component of the risk associated with any asset can be offset by other assets. In practice, diversification is more often used in the broader context of portfolio efficiency. An investment strategy or asset class is said to provide diversification benefits if it is expected to improve a portfolio's risk-adjusted return (or Sharpe ratio).[25] If the risk-adjusted return for a new asset class is deemed to be very attractive over the short term, but the long-term or equilibrium-risk-return characteristics of the asset class resemble those of another asset class, then the new asset class does not really provide meaningful diversification benefits over the long term. Also, asset correlations tend to rise in the event of major shocks like the 2008 financial crisis. These tendencies limit true diversification, which is only effective across asset holdings that have significant and persistent underlying differences in their risk factors or return-generating processes. Further, long-term portfolios tend to be more concentrated than short-term portfolios, because long-term investors acquire and hold more information about each asset. But if a long-term portfolio is soundly constructed relative to key underlying risk factors, it should not be more risky than a short-term portfolio with higher turnover and more uncertain future content.

6. **Long-term investors can benefit from their ability to buy and sell at any time without compulsion, and can reap the rewards of long-term outcomes whose short-term path is uncertain.**
   Long-term investors have the stability of funding to undertake an investment where the future timing of its positive payoff is quite uncertain but where they believe there is a high probability that it will occur eventually. By contrast, this investment will be much less appealing, or even prohibitive, for short-term investors who (i) have a strong desire or pressure for more immediate results, (ii) avoid the investment because of the near-term prospect of negative news or the lack of an evident catalyst for markets to reward positive developments, or (iii) excessively discount potential long-term earnings.[26] The absence of a compulsion to sell investments when prices are temporarily depressed or to buy when they are temporarily excessive, and the ability to accept path-uncertainty in expected payoffs, are clear advantages for the long-term investor.

7. **Long-term partnering relationships (between owners and managers and between investors and investees) foster better and more sustained returns.**
   Asset owners should develop partnering relationships with managers who can help achieve the long-term mission. Patient partnerships that go beyond purchaser/seller contracts build trust and provide mutual support. The right manager can help an owner identify new opportunities and prioritize existing ones. Closer relationships with well-aligned asset managers can enhance the comfort that boards, trustees and beneficiaries of institutional investors have in the managers' capabilities, providing a stronger license to negotiate short-term disturbances. Meanwhile, investee companies can focus on building long-term value because they know that their stocks and bonds are being held, and their capital is being supplied, by patient investors.

Below, we provide a case study on implicitly or explicitly held investment beliefs around responsible investing as an illustrative example of how some institutional investors approach this issue.

Case Study:
Implicitly or explicitly held investment beliefs related to responsible investing

Many institutional investors hold investment beliefs that relate to responsible/sustainable investing. It seems likely that more investors will adopt such beliefs in the future. However, some of these beliefs function mainly as communication devices, rather than maintaining sound investment processes. Moreover, not everyone agrees that long-term investors need responsible investing beliefs. We provide three points that contribute to this debate:

- Most relevant studies find a positive link, with no neutral or negative results, between companies with high environmental, social and governance (ESG) or corporate social responsibility (CSR) ratings and lower ex-ante cost of debt and equity on average. Good ESG practices are more highly reflected in accounting-based financial performance than market-price performance,[27] possibly because the market is only beginning to take such information into account.
- Companies with high ESG/CSR ratings tend to display stronger financial performance measured by rate of return on capital or stock-price appreciation.[28]
- Of the three ESG factors, governance has to date been viewed by most investors as the most important variable for corporate performance, followed by environmental and social factors—except where there are egregious practices in either of the latter two areas. However, the longer the investor horizon, the more weight may be given in beliefs to environmental risks and opportunities, and to social impacts.

As examples, consider:

Investor	Belief
APG	"The way APG manages its clients' pension assets is about more than realizing financial gains. On behalf of our clients we implement the Responsible Investment Policy. Therefore we take account of environmental, social and governance (ESG) factors as an integral part of the investment process in order to: contribute to risk-adjusted financial returns; demonstrate social responsibility and; contribute to the integrity of financial markets." *Responsible Investing*, APG, 2015, **apg.nl**.
ATP	"We believe that integration of responsibility in investment decisions contributes to a high risk-adjusted return." *Responsible Investments*, ATP, 2015, **atp.dk**.
British Columbia Investment Management Corporation (bcIMC)	"We believe companies that take environmental, social and governance (ESG) matters into account have less risk and generate better long-term value than do companies with less robust practices." *Responsible Investing*, bcIMC, 2014, **bcimc.com**.
BT Pension Scheme	"The Trustee has a fiduciary responsibility to meet the Scheme's liabilities and as a long-term asset owner considers sustainable factors to improve long-term risk-adjusted returns. The area of sustainability as defined by the Trustee covers long-term factors such as environmental, social and governance (ESG) and stewardship." *Responsible Investment*, BT Pension Scheme, 2015, **btpensions.net**.
Canada Pension Plan Investment Board (CPPIB)	"CPPIB believes that responsible corporate behavior with respect to ESG factors can generally have a positive influence on long-term financial performance, recognizing that the importance of ESG factors varies across industries, geography and time." *2014 Report on Sustainable Investing*, CPPIB, 2014, **cppib.com**.
Generation Investment Management	"Our investment philosophy is based on our conviction that sustainability risks and opportunities directly affect long-term business profitability. We believe the interests of shareholders, over time, will be best served by companies that maximize their financial return by strategically managing their economic, social and environmental performance." *Generation's Investment Philosophy*, Generation Investment Management, 2015, **generationim.com**.
NZSF	"Responsible investors must have concern for environmental, social and governance factors because they are material to long-term returns." *Investment Beliefs*, The Guardians of New Zealand Superannuation, NZSF, 2014, **nzsuperfund.co.nz**.
Ontario Teachers' Pension Plan (OTPP)	"Good governance is good business and contributes to sustainable values. We continually consider all risks in our investment process, including those related to environmental, social and corporate governance factors. We expect management teams and boards of directors to be responsive to their shareholders. We lead by example." *Our Investment Beliefs*, OTPP, 2015, **otpp.com**.

Investor	Belief
PGGM	“PGGM is convinced that taking ESG factors into account contributes to good risk management and can ensure that achieving financial returns goes hand in hand with sustainable social improvements.” *Asset Management: let us help you put your investment portfolio together*, PGGM, 2015, **pggm.nl**.
QIC	“We believe that environmental, social and corporate governance (ESG) factors are likely to have an increasingly material impact on the long-term returns of investment portfolios.” *Responsible investment*, QIC, 2015, **qic.com.au**.
Environment Agency Pension Fund (EAPF)	”We recognize that environmental, social and governance (ESG) issues can adversely impact on the Fund’s financial performance and should be taken into account in the funding and investment strategies.” *Responsible investment*, EAPF, 2015, **eapf.org.uk**.
Universities Superannuation Scheme (USS)	“Responsible investing requires a full view of risks and opportunities. Environmental, social and governance (ESG) factors should be integrated into the investment process of our managers, whether in-house or external.” *Investment Beliefs*, USS, 2015, **uss.co.uk**.
Washington State Investment Board (WSIB)	“The WSIB has a long investment horizon and therefore is subject to complex and systemic global risks that unfold over time, including financial risks resulting from global climate change. Many of these risks are difficult to quantify, but nevertheless, we consider all identifiable risks in our investment process and believe thoughtful consideration of these evolving global challenges is inseparable from long-term investment strategy and performance.” *WSIB Investment Beliefs*, WSIB, 2015, **sib.wa.gov**.

The formulation of beliefs

Iverson (2013) promotes a modified version of Damodaran’s (2003) three-step process for institutional investors to develop a set of investment beliefs that will advance their long-term investing goals[29]:

- Understanding the fundamentals of risk and return by forming views on the valuation of assets and implementation costs;
- Developing a sound understanding of how markets work, and especially of the degree to which they are efficient;
- Formulating beliefs in the context of a fund’s horizon, cash flow profile, tax status, and risk tolerance.

Beliefs work best when they are consistently understood and held by all stakeholders in an enterprise. The strongest and most useful set emerges only through the deep involvement of all stakeholders in at least some part of the beliefs formulation process, and then through a formalized recognition of the final set of approved beliefs. Beliefs should only be abandoned, revisited or changed when something fundamental changes that calls them into question. For example, short-term volatilities are not enough to question the integrity of a belief; instead, it is this integrity that allows an institution to negotiate short-term considerations. However, a change in institutional mandate, in the prospective long-term risk-return profile of assets, or in the structure of liabilities can certainly provide the right opportunity to re-establish a set of investment beliefs.

Below, we provide examples of the processes that a couple of institutional investors went through to develop their investment beliefs.

Idea in action: Investment beliefs offsite

As Ontario Teachers' Pension Plan (OTPP), a major Canadian pension fund, grew from a handful of investment professionals to several hundred, management decided it was prudent and useful to codify its collective investment beliefs.[30]

A few months of smaller meetings, discussions and pre-readings culminated in a one-day offsite that gathered about 100 senior investment professionals to explore the organization's fundamental beliefs. The level of management commitment signaled that the exercise was a key part of establishing OTPP's investing culture.

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

Idea in action: Aligning the board and management

The Washington State Investment Board, a public pension fund, started the process of developing and documenting its investment beliefs by hiring a consultant to work directly with their board.[31] Identifying the beliefs and then getting 15 board members to agree proved quite challenging and, while the board was not against the process, their first attempt was unsuccessful.

The executive director, chief investment officer, and senior investment staff then undertook a year-long journey of identifying the staff's investment beliefs. Through this process they discovered that sometimes the investment beliefs were self-evident, sometimes it was a discovery, and other times it was about understanding the difference between what they wanted to believe versus their actual behavior. As is often the case, the process was as valuable, if not more so, than the final result.

Once staff had documented their investment beliefs, the beliefs were presented to the full WSIB board for further discussion, which then resulted in a set of board-adopted investment beliefs for the retirement fund focused on the areas of mission, risk, asset allocation, active management, performance measurement, and organizational core competencies. Ongoing maintenance of the beliefs includes reviews as needed. Additionally, to keep the staff, management and the board of WSIB accountable, the beliefs are reviewed formally as part of each retirement fund asset allocation study.

For WSIB, investment beliefs are the fundamental assumptions or principles on which an investment program and its policies are premised, and reflect the essence of an investment philosophy. The beliefs ensure alignment of understanding between the board and staff, and aid good governance by guiding decision-makers in developing, executing, and monitoring investment strategies.

2 Risk appetite statement

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

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

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

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

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

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

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

Idea in action: Defining and communicating risk

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

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

To be more relevant to the long term, a major national pension reserve fund proposed the following criteria for its primary risk metric: (i) potential loss over multi-year horizon; (ii) forward-looking, rather than based solely on historical data; (iii) recognize reported "fair values" for private assets; (iv) capture all material risks, not just systematic risks; and (v) incorporate both the likelihood and magnitude of tail losses.

Risk is multidimensional, and capital markets are complex. Although investors may choose a primary concept for risk, no single metric can *fully* capture risk. Investors thus need to apply a range of metrics linked to different time horizons, including an examination of stress scenarios related to adverse future economic and market conditions. Just as important, investors also need to establish minimum acceptable risk levels, and associated minimum acceptable expected returns, because too little risk can cause an organization to earn insufficient returns and fall short of meeting its liabilities or other strategic objectives.

Institutional investors span an extremely broad range of strategic orientations, ranging from short-term algorithmic trading strategies to long-term investors like Berkshire Hathaway and organizations with indefinite horizons like sovereign-wealth funds. Clearly, organizations with short-term investment horizons will focus more on operational risks. At the other extreme, even firms like Berkshire Hathaway are operationally complex enough to need to address a variety of risks, but their RAS is likely to be a fairly short document focused on investment principles. Most institutional investors fall somewhere in the middle and must balance a range of short- and long-term principles and risks. Below we provide different elements that institutional investors can consider when developing their risk appetite statements.

Key risk identification

Framework: Key risks

Managing the asset				
Investment risk	Liquidity and funding risk	Valuation risk	Counterparty and collateral	New products and markets

Managing the organization			
Operational risk	Strategic risk	Fiduciary risk	Reputation risk

Managing the environment			
Peer comparisons	Legal, regulatory, government	Sponsor default	Client actions

Every organization should start by identifying the key risks that should be covered within their RAS. In the diagram above, we list some typical key risks relating to assets, the organization and the environment in which the organization operates. All institutional investors face investment and operational risks. Other risks may affect only certain organizations. In general, the risks associated with asset management will be a function of the nature and purpose of the assets and investment strategy.

The scope becomes more customized when we try to measure risks related to the investing environment. For example, an investment organization with a government sponsor may decide that a sponsor default is out of scope. Pension plans and asset managers tend to face very different client actions. A pension plan will be affected by changes in benefit promises, while an asset manager will be most concerned with client withdrawals. A good example of a key risks framework is Washington State Investment Board's risk appetite statement (see **sib.wa.gov**).

Risk reward and risk intention

Framework: Actions by risk reward and risk intention

		Rewarded	
		Yes	No
Intended	Yes	Size and manage	Mitigate
	No	Understand	Avoid

As shown in the chart above, risks can be classified as rewarded or unrewarded, and as intended or unintended. Risks that are both rewarded and intended should be managed at an appropriate size to meet the organization's strategic objectives. Risks that are not rewarded need to be mitigated or avoided. Risks that are rewarded but unintended can indicate inadequate control or that the organization does not fully understand its risk profile; for example, when gains or losses are in well in excess of what could reasonably have been expected. In the diagram below, we give examples of the types of risks that fall into each of these categories.

		Rewarded	
		Yes	No
Intended	Yes	Investment, illiquidity	Operational, counterparty
	No	Unexpected gains/losses	Reputation, fiduciary

An RAS may choose to address fiduciary risk by articulating clear policies and a strong code of conduct that align the organization to its beneficiaries, with zero tolerance for breaches. Other risks are relevant for the day-to-day practice of long-term investing. Investment risk is clearly the paramount risk, followed by reputation and strategic risk. Valuation risk is typically not an issue for long-term public equity investors. Similarly, illiquidity, collateral, and new market risks are all less important for long-term investors than for shorter-term investors who have to actively consider those risks.

Ability and willingness to take risk

Framework: Type of portfolio by ability and willingness to take risk

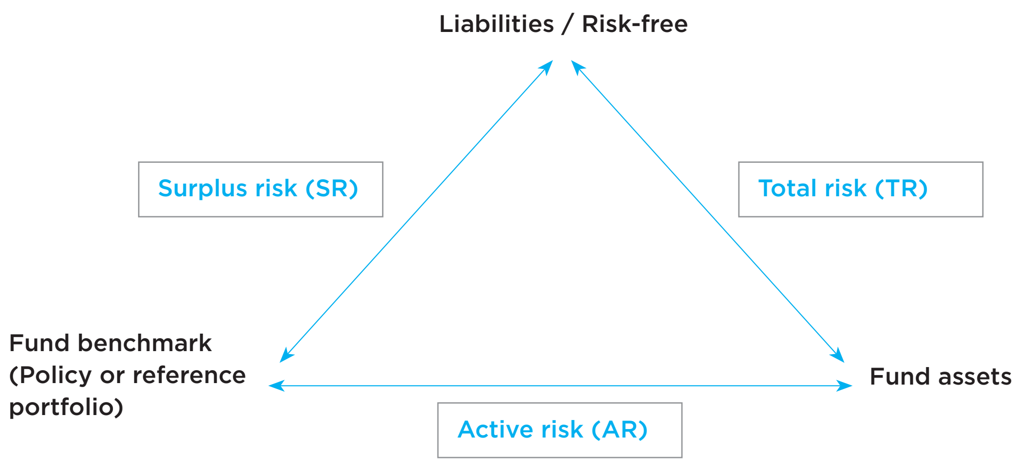
		Willingness	
		Low	High
Ability	Low	Simple, conservative	Need to lower willingness and/or increase ability
	High	Complex, conservative	Complex, aggressive

The RAS should start by identifying relevant risks and determining how to address different risk categories. Next it should focus on intended and rewarded risk, which is essentially investment risk. The RAS should align the organization's capacity, ability and willingness to take risk with the type of portfolio that it manages. A simple portfolio will primarily contain public equities and bonds, avoiding illiquid assets, derivatives and leverage. Large, sophisticated pension funds generally have a high ability to take risk. However their willingness to do so will depend on the maturity of the plan, its funding status (asset/liability ratios) and the financial strength of the plan sponsor. In contrast, many sovereign-wealth funds and national pension reserve funds combine high capacity, willingness and ability to take risk.

The ability to take risk is a learned skill that distinguishes accomplished investors with sufficient resources from average ones. In practice, investors with a high ability to take risk tend to wind up managing complex portfolios. Finally, it is hard to imagine an organization with high willingness to take risk but low ability to sustain success managing a portfolio that is both aggressive and complex.

Total and relative risks

Framework: Total, surplus, and active risk interaction



$$\boxed{TR^2 \approx AR^2 + SR^2 + 2AR * SR * \rho_{AS}}$$

ρ_{AS} is the degree of correlation between active risk and surplus risk, which is usually positive but quite low.

Portfolios of risky assets are typically managed to meet a long-term strategic objective. This objective can frequently be expressed as a "liability" for which we can calculate both present value and risk. For example, a pension plan may have liabilities to pensioners and active members. An endowment may compute a liability as the need to meet a certain percentage of the organization's operating costs. In the context of liabilities, it is not the stand-alone risk of the assets that matters, but the risk of the assets relative to the liabilities.

In the framework above, the risk of assets relative to liabilities is shown as total risk, measured as the volatility of the difference between current values of actual assets and liabilities. Total risk can be decomposed into (1) surplus risk (which arises from the mismatch between assets and liabilities and is measured as the volatility of the difference between current values of policy or reference portfolio assets and liabilities), and (2) active risk (that is, risk of deviations of the actual portfolio assets from the policy or reference portfolio). Even without an explicit liability, the risk-free rate or inflation may be used in its place, preserving the risk decomposition. Regardless of the specific definition of risk, it can generally follow the triangular decomposition given in the green-boxed formula above.

An RAS may provide guidance on the desired decomposition of the total risk. For example, two organizations may decide to take on the same total risk. The first organization might pursue its objective by closely tracking a policy or reference portfolio with the targeted risk level. The second organization might deploy a much greater degree of active management but a less risky policy or reference portfolio. This is a fundamental topic to address in an RAS, as an appetite for active risk indicates a belief that financial markets are inefficient and that the organization's managers have the active investing skill needed to outperform benchmarks.

The appetite for active risk should depend on its quality. While investment organizations all define risk quality differently, the definitions typically combine high and reliable risk-adjusted net-of-costs performance with low correlation to the policy or reference portfolio.

Key aspects of risk appetite

Below, we provide some key questions for organizations to ponder when formulating a risk appetite statement:

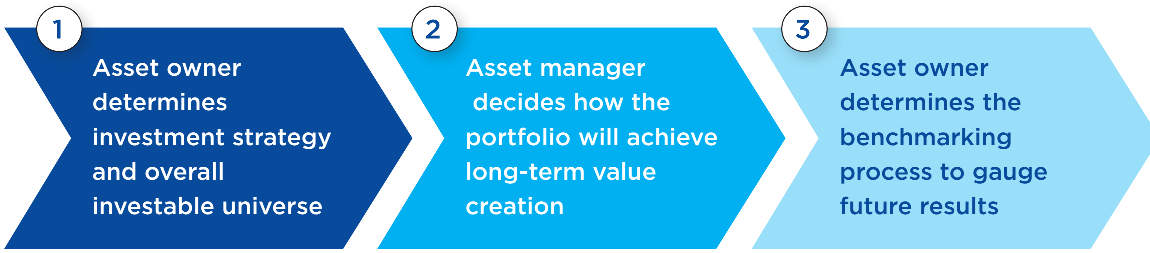
- What is the goal of the organization? Does it have a single mandate, such as earning high returns, or does it have a dual mandate, such as earning returns and fostering economic growth in the sponsoring region?
- Why is the organization taking risks? The risks taken should be consistent with the organization's investment strategy and governance structure.
- What are the sources of risk and risk premiums that the organization hopes to get exposure to?
- What risks will be managed and what risks will not, or cannot, be managed, such as longevity risk, default of sponsor, and so on? What risks will the organization not take or minimize as much as possible?
- How will the organization measure risk? Although standard deviation is the most common measure of risk, it treats gains the same as losses and thus may be a less relevant descriptor of risk than other measures that focus on loss potential, such as downside volatility, value at risk, expected tail loss, and permanent loss of capital.
- What is the amount of risk that the organization is willing to take? Possible examples "somewhat more aggressive than, our peers," or "no greater than 10 percent chance of losing more than $XXX million in real terms on the original capital after five years."
- Is the risk measured on an absolute or relative basis or both? If relative, what is it relative to and why? A known set of liabilities? A benchmark? Appropriate peers?
- What are the relevant time horizons over which risk and return will be measured and evaluated?
- Which risks are the board's responsibility, and which are the responsibility of management?
- Within management, how is independence assured between overall risk-monitoring, measurement and reporting, and the investment decision-making departments?

3 Benchmarking process

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

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

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



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

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

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

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

Strategy benchmarks

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

Existing strategic benchmarks include the following:

- a multi-year absolute return target, for example, inflation + X percent
- a blended index that conveys the long-term exposure and risk expectations of the strategy. For example, Caisse de dépôt et placement du Québec's Global Quality Equity (GQE) portfolio is *measured* (not managed) against

85 percent MSCI ACWI unhedged plus 15 percent DEX 91-day treasury bills. The strategy of this portfolio is focused on established companies with proven business models, exposure to global growth and stable earnings over the long term. The construction and management of the GQE portfolio is therefore benchmark-agnostic[32]

- The opportunity cost of investing in the strategy, such as an all-country or regional equity index that represents the funding source for securities selected in the portfolio

Execution benchmarks

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

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

- fundamentals-based indexes, for example, Russell or RAFI Fundamental indexes
- "quality" indexes, for example, MSCI or S&P products carrying this label
- non-market-capitalization-weighted indexes; for example, Norway's Norges Bank Investment Management has proposed a generic modeling framework that does not weight member companies by market capitalization. Instead the framework takes sector characteristics, manager skill, risk appetite and market states into consideration[33]

If the mandate is clear, if the true evaluation horizon is sufficiently long (at least five years),[34] and if the asset owner and manager are sufficiently aligned, they may agree that a distinct execution benchmark is not necessary and the strategy benchmark can serve both purposes. Then, by having the fortitude to accept likely deviations and stay-the-course, asset owners can encourage asset managers to focus on producing long-term returns that best achieve strategic objectives for clients and beneficiaries at the appropriate risk level.

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

Evaluating benchmarks as effective tools for long-term investing

As noted earlier, the strategy benchmark serves to clarify and set the objectives for the asset owner's overall investment strategy itself. The execution benchmark guides the asset manager's execution of that strategy.

Key considerations for strategy benchmarks

Ideally, the strategy benchmark will encourage asset managers to think like business owners by assembling a portfolio of superior, long term-oriented companies rather than focusing on quarterly returns.

If the portfolio mandate is oriented to absolute returns, the strategy benchmark needs to represent a feasible and reasonable long-term expectation for returns based on the risk factors inherent in the specified opportunity set. Examples could include:

- Asset owner's internal return objectives, that is, a required rate of return, possibly with a risk expectation.
- N-year investment grade corporate nominal bond yield plus expected N-year relevant equity risk premium, that is, an expected rate of return.

- For asset owners with a particular focus on preserving purchasing power, the expected rate of overall organic real growth of corporate net earnings (excluding new capital formation).

If the portfolio mandate is oriented to relative returns, the strategy benchmark may be best determined as either:

- the opportunity cost, that is, an index representing assets that will be sold to finance the portfolio;
- a formulation representative of the risk target (such as X percent broad market index + (100-X) percent cash); or
- a simple low-cost investable alternative.

Portfolios oriented to relative returns will also need an execution benchmark incorporating drivers that align with long-term value creation. We outline potential elements of such a benchmark index later in this section of the paper. The actual portfolio constructed under a long-term mandate will likely be much more concentrated than any conventional benchmark. Portfolio returns will also tend to exhibit wide shorter-term variance from, and quite low correlation with, the benchmark in question. However, they may well also show greater propensity for long-term reversion to intrinsic values. Benchmarking measures that use short-term volatility of monthly returns to "risk-adjust" may thus provide misleading impressions of the underlying long-term risk of the portfolio, which will ultimately depend far more on the quality of the selected securities.[35]

Key considerations for execution benchmarks

To fulfill the total return objectives of their long-term clients (that is, asset owners and the beneficiaries they represent), we recommend that asset managers consider how to deliver sufficient long-term absolute returns, not simply benchmark-relative management approaches. In doing so, asset managers will need the flexibility to increase cash holdings to a significant percentage of the portfolio when market pricing is unduly high and return expectations are depressed. In the absolute return approach, the execution benchmark should primarily be chosen to assist in monitoring the manager's adherence to the intended mandate and the expected portfolio-construction process.

Relative return strategies tend to be either more passive in nature, or seek value added but with less latitude for deviation from the benchmark. As a result, the execution benchmark should incorporate a balanced set of growth and operational factors that indicate the sustained viability of each constituent. Such benchmarks can then balance the information embedded in market capitalization with other fundamental metrics that demonstrate the potential for sustained and stable corporate financial returns over the long run, that is, at least five years.

Incorporating drivers of long-term value creation (LTVC) in benchmark construction

Benchmark construction and constituent selection can influence corporate behavior by highlighting the company's suitability for investment and potentially directing corporate management focus to metrics that are of interest to long-term investors. While progress has been made in the last few years with the creation of nontraditional indexes that are not solely focused on market capitalization, more can be done to design and utilize benchmarks that foster a longer-term orientation. If widely adopted by asset owners and managers, such benchmarks may well also influence boards and management at investee companies, resulting in more efficient deployment of corporate strategies and capital aimed at long-term growth rather than short-term impact on stock price.

The recently launched MSCI Global Low Carbon Leaders Indexes provides an example of such collaboration among index providers, asset owners and asset managers. The indexes, which consist of companies with significantly lower carbon exposure than the broad market, were created in September 2014 by MSCI at the request of, and with critical insights from, Fourth Swedish National Pension Fund AP4, Fonds de Réserve pour les Retraites (FRR), and Amundi. MSCI created the indexes and Amundi licenses them to create index-tracking solutions. Finally, AP4 and FRR plan to use the indexes as benchmarks for their passive mandates.[36] We believe that this model of collaboration between index providers, asset owners and asset managers can be extended to create fundamentally weighted indexes composed of companies that focus on long-term value-creation factors.

In the long term, the evolution of the share price of a company will primarily reflect the company's earning power. Likewise, the investor's return will come to depend more on corporate cash flows, dividends and reinvestment than on changes in the stock price.[37] Overall, we believe that shifting to widespread use of public equity benchmarks that have a greater emphasis on long-term corporate viability and profitable growth, and the accompanying change in investor and investee behavior, could eventually yield materially greater and more sustainable value creation for the global economy.

Practical steps to constructing an LTVC benchmark index

To be useful, any benchmark must meet the needs of both asset owners and managers. The benchmark will set the asset owner's expectations of the investment strategy. It will also serve as a tool for asset managers to measure overall success. It follows that a benchmark index focused on long-term value creation should:

- be explicit and unambiguous regarding the requirements for companies to be included in the index and the criteria for their weighting;
- appropriately reflect the asset owner's objectives;
- help identify true long-term value creation, both by the index itself as a passive portfolio and by the active asset manager in adding alpha; and
- be investable and readily measurable.

We recognize that asset owners and managers currently lack access to a wide range of long term-focused benchmark indexes. In this section, we do not make a sharp distinction between asset owners and managers because we believe that benchmarks oriented toward long-term value creation should be co-designed in an aligned partnership between them. In the short term, investors may want to adapt current indexes/benchmarks or develop their own. In the latter case, we recommend that investors consider incorporating the following factors:

1. **Basic construction considerations** (usually directed by the asset owner)

a. *Ensure relevance when used with a longer primary measurement period*
While the period over which the strategy is measured and evaluated will differ for each asset owner, it should be sufficiently long (at least five years) to promote long-term behavior. The goal of a longer assessment period is to steer the focus away from short-term share price movement to long-term intrinsic value creation. Low turnover in index constituents should thus be expected. "In the short run, the market is a voting machine, but in the long run, it is a weighing machine," as Benjamin Graham wisely said. However, the correlation between share price and underlying profitability strengthens over time, and therefore investors should consider defining interim progress milestones and appropriate tracking tolerance bands.

b. *Weigh the benefits of concentration over diversification*
We believe that concentration in the actual managed portfolio is more an ex-post result of portfolio construction than an ex-ante criterion. Statistically, an absolute return-focused strategy requires only about 25-30 stocks with an average degree of noncorrelation to diversify away most of the nonsystematic risk in a portfolio.[38] For a relative return-focused strategy, a benchmark index defined as the opportunity set would likely require five to ten times that number. This implies a benchmark universe of at least 125 stocks. Assuming sound sector and other diversification constraints, a benchmark sample of this size may well suffice without needing to have 2,000+ stocks as is the case for most conventional world equity indexes.

c. *Consider scalability*
Indexes will only remain practical and widely used if they can absorb meaningful quantities of capital. Usually, investors scale the opportunity set by broadening the investment universe. Instead, we recommend focusing on a smaller but more relevant universe. A larger universe does provide more flexibility for trading, assuming that portfolio holdings are constrained to be within the index. However, a smaller subset of operationally excellent

companies should achieve better long-term value creation via compounding sustained underlying corporate cash flows and returns. Through the asset owner/manager agreement in the mandate, actual security holdings need not all be constituents of the index. This recommendation is consistent with a longer primary measurement period.

2. **Operational excellence drivers** (usually proposed by the asset manager and agreed to by the asset owner)

Absolute return-focused strategies are evaluated in reference to the asset owner's long-term expectations. Investing in operationally excellent businesses with good alignment to long-term value creation increases the odds of achieving the asset owner's objectives. For relative return-focused strategies, we recommend incorporating operational excellence drivers in the execution benchmark to reflect anticipated long-term value creation. If these drivers are largely indifferent to current market capitalization, the resulting benchmark should give increased weight to smaller yet operationally excellent companies that have high potential to create economic value.

a. *Focus on long-term returns*
For a long-term investor, the most important criterion is the sustainable growth of long-term earnings per share. All things being equal, a company with healthy operating performance (for example, return on equity (ROE), return on invested capital (ROIC)) and good growth prospects is a candidate for generating sustainable value. Identifying companies that satisfy both these conditions can be difficult because achieving high current levels of operating performance and maximizing growth are often conflicting corporate objectives.

Equity portfolio returns should not be ultimately driven by short-term fluctuations in the market, but rather by sustainable returns and profits earned by the underlying corporations. Focusing solely on short-term ROE or ROIC could discourage long-term investment and sacrifice growth in the long run. Hence, we recommend an average five-year rolling assessment period on these return metrics.

b. *Focus on profitability*
Investors normally take profitability measures into consideration when estimating a company's long-term growth potential.[39] Profitability can be expressed by the operating margin (OpM) or free cash flow margin (FCF margin). Because the intrinsic value of a company can be defined as cash flow generated over the business lifecycle discounted at the investor's cost of capital, we believe it is most appropriate to express profitability using cash metrics such as FCF margin. Again, we propose a five-year rolling period to smooth out metrics employed so that cyclical companies are not put at a disadvantage.

Leverage and size (as expressed by market capitalization) also play an important role in benchmark construction. Because market capitalization assumes long-term growth based on fluctuating market expectation and valuations are affected by investor sentiment, it is a source of volatility. However, for corporations that are willing to forgo near-term operating profit and return in exchange for long-term dominance, market capitalization can also reflect value creation. We believe that in order to reduce short-term behavioral influences on long-term growth expectation, a long-term benchmark should address size by coupling operating profits with market capitalization, rather than focusing solely on the latter.[40]

3. **Long-term business viability factors** (usually defined by the asset manager)

a. *Governance considerations*
There is substantial empirical evidence to suggest that good governance ultimately yields better corporate returns. Gompers, Ishii and Metrick (2003) constructed a "Governance Index" and ranked companies based on their scores.[41] To achieve high governance scores, companies must have provisions against contracts or behaviors associated with bad governance, such as golden parachutes, poison pills, unequal voting rights for shareholders and greenmail transactions. Proper executive compensation structures focused on the long term should also be an aspect of good governance. In practice, we observe that companies with good governance practices typically

now trade at a premium over their peers. This is particularly true in some emerging markets where overall standards of corporate governance tend to lag those observed in most developed markets.

We propose a governance index hurdle to ensure that companies considered for the benchmark have appropriate governance measures in place, such as performance-based compensation that is not excessive and has a deferred component, a majority of the board comprised of truly independent directors with relevant experience, and a verifiably independent audit committee.[42]

b. *Environmental and Social (ES) considerations*
We also recommend that companies in the index be required to clear reasonable environmental and social hurdles. For a further examination of the utility of environmental and social hurdles, see the case study on Responsible Investing in the *investment beliefs* section of the paper.

While some currently available indexes focus on ESG factors, most do not sufficiently incorporate broader long-term value creation factors (for example, five-year rolling ROIC, ROE, and so on) that are critical to the asset owner. For a long-term investor, the most important criterion is the sustainable growth of long-term earnings per share. All things being equal, a company with healthy operating performance (ROE, ROIC) and good growth prospects is a candidate for generating sustainable value. Asset owners must decide whether to build a customized new index or wait for such indexes to become commercially available. Asset owners who choose the latter course can use the following criteria to select from several newer, nontraditional benchmark indexes that are not based solely on market capitalization:

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

Compared to traditional benchmarks, these indexes may often be better fits for long-term mandates.

Idea in action: Abandoning traditional market cap weighting[43]

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

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

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

4 Evaluations and incentives

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

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

Asset owners who use short-horizon performance assessments will often hire and fire managers at the wrong time. The evidence suggests that short-term switches by asset owners from one asset manager to another have tended to destroy value.[44] Likewise, managers who feel pressured to match unrealistic benchmarks or client expectations are more likely to make reactive misjudgments or fail to include their best long-term ideas for fear of short term underperformance. Instead, short-term assessments should focus on whether portfolio management is being carried out in a manner consistent with stated beliefs and expected processes. True asset performance should be measured over at least a full market cycle—often five years or more.

The asset owner-manager relationship – transparency and mutual trust

Given the nature of long-term investing and its necessary departure from what has become industry-standard monthly and quarterly performance measurement, the relationship between asset owner and asset manager becomes ever more important as both parties are entering into a long-term agreement with potentially hard-to-define short-term measures of success. During the initial selection process, the asset owner needs to screen asset managers to ensure that the chosen manager shares the asset owner's investment beliefs and is aligned to the asset owner's long-term objective, and that the organizations are culturally compatible. After initial suitability screening, due diligence for manager selection should combine three aspects:

1. Careful assessment of people, philosophy, processes and potential partnership as the primary element.

2. Past performance, which cannot and should not be ignored, but recognizing that shorter-term value added depends heavily on luck. More informative are the characteristics and context of performance: up markets vs. down, risk-adjusted, consistency, etc. However, this information should still be interpreted cautiously given limited observations and/or varying market conditions. The key is for the manager to demonstrate, and the owner to analyze, how (a) the portfolios and processes that the manager has built (fundamentals, buy/sell decisions and risk management) and (b) the *pattern* of the resulting performance provides evidence of the long-term philosophy and process in effective action.

3. Manager fees and internal incentive structures that align with long-term asset owner objectives.

Asset prices and portfolio performance (however measured) will inevitably fluctuate in the short term, especially in the more concentrated portfolios that tend to be characteristic of long-term investment strategies. Dealing with this reality requires trust between asset owners and managers. Owners need to feel confident that asset managers will not abandon core investment strategies under short-term market pressure. Similarly, asset managers need to feel confident that owners will not withdraw funds due to short-term volatility, impatience, unrealistic expectations or extraneous liquidity needs.

To formalize a trust-based relationship, owners and managers need clear investment mandates and pre-agreed expectations for performance evaluations (see *investment mandates* section for details). But in order to build the mutual trust needed to sustain a successful long-term strategy, transparency (around portfolios, processes, decisions, personnel and results) plays a crucial role.

Transparent portfolio management strategy and honest communication about performance in good times and bad are critical to developing mutually beneficial, long-term relationships between asset owners and managers. Managers need to be prepared to justify sales, purchases, and individual holding successes and failures in regular communications with asset owners – not so much in terms of wins and losses, as both will occur, but rather in terms of process. While this process requires discipline and fortitude, it does not imply unflagging attachment to "style". To the contrary, adaptability is an essential component of successful long-term investing because economic and investment regimes inevitably evolve over time. Transparency and mutual trust allow asset managers and owners to adapt successfully together. Asset owners need to be clear about how much transparency they require in order to gain this comfort. For their part, asset managers need to be honest about how they assess their own performance.

Qualitative evaluations

As noted above, qualitative evaluation is extremely important in the initial due diligence of a fund manager. It is at least equally important in the initial phase of the asset owner/asset manager relationship in the period before a fully credible performance record can be established, that is, before skill starts to be distinguishable from luck. Well-selected managers should rarely be fired for short-term underperformance relative to quantitative measures.[45] However, dismissal may be justified if the manager deviates significantly from the investment mandate without adequate transparency and explanation. Dismissal may also be justified if the fund manager's organization fails to communicate its actions and performance effectively or has lost necessary competencies.

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

1. key personnel changes/corporate ownership
2. robustness of stated process, and adherence to beliefs and philosophy
3. evidence of effective risk management
4. ability to coherently express ideas and effectively implement them
5. transparency of decision-making and performance attribution
6. loyalty to research agenda

Asset managers themselves are increasingly adopting qualitative measures of performance against longer-term mandates. State Street Center for Applied Research has developed an interesting behavioral framework of factors to identify key behaviors and patterns that may help define true skill in the asset-management industry.[46]

Idea in action: Focusing on qualitative factors to measure performance

Aberdeen Asset Management, a publicly held asset manager headquartered in the United Kingdom, focuses more on qualitative measures rather than quantitative ones when evaluating portfolio managers. For example, managers are evaluated based on their patient adherence to long-term process as observed by peers. Determinants include the quality of their company research, interaction with colleagues and idea generation. Discretionary annual bonuses typically are structured as 25 percent cash and 75 percent deferred compensation (for three- to four-years).

The area of qualitative evaluation is one where there may be distinctions between internal and external managers, and between privately and publicly owned organizations. For external asset managers, it is extremely important to continue to ensure the internal alignment of interest with external clients first on the longer-term “qualitative” aspect and only then on the often more apparently pressing and immediate “monetary” part. For publicly owned firms, and mutual fund managers in particular, this is made more difficult, and thus more necessary, by the short-term external pressures they face. The process of qualitative alignment of interest for internal managers, however, has a very different “client” dimension. Despite differences in this dimension, those of us with sizeable internal management staff are aware that the key to success lies in the recruitment process and how that process lives through the organization’s culture, beliefs and actions on a daily basis.

Quantitative evaluations

Despite the importance of structured qualitative assessment, we cannot ignore the fact that active asset managers operate under mandates that over time demand significant value creation, however that may be defined. A degree of quantitative assessment is thus unavoidable. The *benchmarking process* section addresses relevant performance benchmarks and benchmarking processes. Here we discuss how to align performance assessments against appropriate benchmarks to encourage a long-term investing orientation.

At the beginning of their partnership, asset owners and managers need to define an appropriate time horizon for evaluation. While the time horizon should recognize the long-term investing objective, evaluations must also consider the reality of an individual asset manager’s circumstances (for example, working conditions, employment life-span, ambitions for career trajectory, career risk, and so on) that may influence his or her behavior in the shorter term.

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

- including the total return relative to the objectives of the asset owner over a stated period (that is, meet or beat the absolute or strategy target)
- evaluating quantitative performance over a minimum of five-year rolling windows[47]
- ensuring that performance fees or internal incentive compensation are earned only at the end of each five-year time horizon. A significant portion of the earned amounts should then be deferred and related to subsequent performance
- relying on qualitative evaluations, specifically tailored to assess the adhesion to, or success of, stated investment beliefs or broad manager strategy, during intervening periods

There is clear evidence in the literature that the ultimate success of a corporation is dependent on sustained earnings growth, and that earnings growth is the dominant driver of stock price returns but only over the long term. Short-term variations in the price of risk and the discounting of future prospects, often heavily influenced by macroeconomic or geopolitical events and by general market sentiment, can overwhelm long-term fundamentals in short-term price discovery and P/E multiples. As long ago as 1934, in their seminal publication *Security Analysis*, Graham and Dodd argued that because short-term price fluctuations tend to distort a company’s “true” valuation, investors should assess valuation ratios using an average of earnings of “not less than five years, preferably seven or ten years.”[48] It is the goal of the long-term investor to see through the short-term noise to the heart of the corporation and to invest in those that they believe will see the fundamentals win out in the long run.

Different investors often focus on different measures in a company’s financial results to predict long-term performance. The same is true for the various aspects of corporate governance. The *benchmarking process* section identifies fundamentals that may be generally relevant to long-term value creation. Asset owners and managers need to agree in advance on certain specific financial and governance metrics that will typically inform their chosen investment strategy, even if other metrics will also influence decision-making at various times and in differing sectors.

The quantitative assessment of a long-term portfolio over and above simple price/return performance can then also be informed by reporting those same metrics and fundamental characteristics at a portfolio level (the "portfolio fingerprint"). Including this important insight into the assessment process means that the assessment is appropriately strategy-specific, rather than one-size-fits-all, and dependent on these agreed indicators. For example, consider an investment strategy based on the belief that higher-quality "investment grade" companies provide the most suitable investment base for long-term investing. In that case, debt/equity leverage ratios, earnings variation and price volatility of the underlying holdings might be determined as key performance metrics. For an investment-grade company, we would typically expect each of these metrics to be lower than in a broader equity market portfolio used as an execution benchmark. By tracking these indicators over time, we should be able to assess whether the manager is investing in line with stated beliefs and mandate expectations.

Similarly, a long-term strategy might benefit stocks that display low volatility while still seeking to add alpha over a relevant index in the course of an economic cycle. These types of stocks will typically exhibit lower beta relative to the broad equity market. As a result, it may be misleading to compare portfolio returns to a cap-weighted equity index, especially in a high-volatility bull market.[49]

Long-term investing is also about allocating capital to deserving companies that act in the long-term interests of their shareholders. All things being equal, the fundamental return ratios of these companies (for example, return on assets, return on equity) should exceed comparable market ratios over the long term. In addition, portfolio turnover and holding period ranges can help assess whether the manager is adhering to his stated long-term strategy. In general, we believe that long-term investors will exhibit significantly longer holding periods for most of their investments than the average market participant.

Incentives for asset management organizations

Fee structures

Asset-based fees grow naturally with the market through no effort of the manager. As a result, long-term asset owners should consider compensating managers with a combination of asset-based and long-term performance-based fees. The goal should be to pay for sustained alpha rather than low-cost beta.[50] Alternatively, some long-term asset managers may be willing to work on a fee-for-service basis. In this case, fees can be fixed without reference to moving asset values or performance. Instead they would be renegotiated at intervals having regard to the owner's objectives and the manager's responsibilities. This approach removes all incentives from portfolio construction. Ideally, it focuses professional managers solely on creating long-term value.

Idea in action:
Incentivizing asset managers to focus on creating long-term value

Canadian institutional fund manager Caisse de dépôt et Placement du Québec (CDPQ) prefers to compensate external asset managers using a mix of low management fees and rolling four-year incentives that get phased out over time. CDPQ has found that prospective managers are often reluctant at first to accept this structure because it does not conform to standard market practice. Once managers understand that the motivation behind this compensation scheme is to foster alignment to longer-term returns, they tend to respond quite favorably given that the scheme focuses on the partnership between CDPQ and the manager over a longer, even indefinite, period. The negotiation process enables CDPQ to better assess which managers they want to partner with as it shows the extent to which asset managers are willing to commit to CDPQ's investment philosophy and strategy.

The effective evaluation time period is critical to ensuring alignment between asset owners and asset managers. A study of pension-plan sponsors that fired their asset managers showed that if the asset owners had retained these managers, their excess returns over benchmarks would have been no worse on average and often better than those delivered by the managers they then hired.[51] In addition, the asset owners would have saved the substantial transaction costs of a manager transition, which often range from 1 to 2 percent of the assets involved.

Incentives for individuals

In the investment industry, particularly in North America, incentive compensation is a standard and significant part of the total compensation package. We believe that institutional investors, be they asset owners or asset managers, need to recruit and retain individuals who share the organization's long-term perspective and goals. Incentives are known to drive individual behavior, and thus warrant careful consideration. What financial incentives will encourage asset managers to behave in a manner consistent with collective long-term investment goals?

It is sometimes said that incentives don't matter if you have the right people. We believe patience, intellectual curiosity and integrity are key characteristics that asset owners should look for when hiring asset managers for long-term mandates. Yet human nature is such that the wrong incentives can cause even the best people to do bad things. Therefore, while asset owners and investment management firms need to recruit portfolio managers and analysts who share the organization's investment beliefs and fit their culture, they also need to utilize incentives that reward behavior consistent with those beliefs.

The purpose of any incentive scheme should be to focus asset managers on the long term. Beyond determining the quantum of an incentive payment, deferral of at least part of its subsequent payment reinforces that focus. This structure is widely used in private equity management, with the payouts then being influenced by the returns earned *after* the initial incentive determination—or even clawed back if cumulative returns fall below a threshold level. Regulators are also pushing the fund management industry toward greater use of deferred compensation.

Any long-term compensation package must achieve a proper balance between these elements:

1. Base salary
2. Performance-based compensation at the portfolio management level (or group or department)
3. Profit or return-sharing at the total firm or fund level
4. If applicable, ownership of firm stock (or near equivalent in a public company).

Performance-based compensation

If the asset manager's performance is to be evaluated over a minimum horizon of five years, it stands to reason that individuals who actually manage portfolios, or who strongly influence portfolios (for example, analysts), be incentivized over a similar time scale. In investment management firms it is relatively common to compensate individuals using a formula based on today's assets under management (AUM) and some weighted combination of one-, three- and five-year performance numbers.

This approach has been rightly criticized as placing too much emphasis on short-term numbers. Effectively, the latest one-year results are included in each component of the calculation. As a result, it encourages managers to churn their portfolios to tap into the latest market trends. While the inclusion of a shorter-term measure does incentivize managers to avoid resting on past laurels, we encourage investment companies to consider assigning significantly lower weight to these results than we typically observe today.

One global manager of mutual funds and other institutional assets uses weights that increase significantly with the measurement period, specifically 15 percent one-year, 35 percent four-year and 50 percent eight-year. Because portfolio results are evaluated over rolling windows of up to eight years, a single year of poor results will have an impact on an investment professional's compensation for a long period of time. This heightens awareness of downside risk, which is important for any long-term investing strategy.

We would assign equal importance in incentives determination to qualitative performance measures because we believe that they underpin and drive long-term quantitative outcomes. Today, a number of large, long term-focused asset managers incorporate peer reviews (for example, annual "360" evaluations) in assessing an individual analyst's or portfolio manager's overall contribution to the investment process. This assessment influences salary reviews; more important, in some firms it also determines as much as 50 percent or more of the annual incentive payment. Key qualitative factors include effective communication, readiness to collaborate with the team, and the ability to influence colleagues through sound argument and constructively challenge and improve the status quo.

Profit-sharing

Profit-sharing is a common element in total compensation at many investment management firms. In the modern investment business, many incentive schemes are heavily skewed toward current assets under management or growth therein. Profit- sharing would be much better aligned with the long term if a larger share were related to the firm's management fees and/or profitability, especially if awards were determined on a long-term performance basis.

Idea in action: Incentivizing long-term behaviors and performance at asset managers

At one large, privately held asset manager, a select group of associates share a portion of the company's annual profits through a points-based compensation plan. Participation in the plan is determined each year based on each employee's recent and long-term contributions to the business, including investment results, investment process and operational effectiveness. For employees who contribute at a very high level, plan payments are a significant portion of their total incentives.

Among asset owners, the equivalent is to base a significant portion of every individual's incentive compensation on performance of the total fund.

Idea in action: Incentivizing long-term behaviors and performance at asset owners

At one large fund, at least 50 percent, and up to 100 percent, of the senior management members' performance-based incentive compensation payment is dependent on multi-year total fund net returns, with at least 25 percent being dependent on total fund returns for all staff in every investment department.

At another fund, the long-term nature of this concept is taken further by allocating the incentive award to an individual account, which is adjusted annually based on total fund rate of return, and a portion of the account is paid to the individual annually.

Ownership

Stock ownership in investment management firms—or an internal scheme operating on the same metrics—is a common compensation tool that directly aligns individuals with the long-term success of their employer. This in turn depends heavily on the long-term success of their client portfolios. While exceptional short-term term results often translate into large increases in assets under management, this may not translate into sustained profitability because assets that are quick to arrive may be equally quick to leave. Often incorporating 3- to 5-year deferrals, the use of stock-based compensation (but not options) encourages the employee to buy into their role and consider their long-term future.

Finally, a related but more powerful tool in terms of alignment with the asset owner is direct and meaningful ownership by asset managers in the portfolios that they manage for owners. Such co-ownership is a common practice in private equity and hedge funds. We encourage its wider use in public equity portfolios.

Idea in action: Ownership

At a privately held asset manager that manages concentrated portfolios driven by fundamentals, the most senior half of the investment team owns direct stakes in the firm. These team members do not receive annual bonuses. Instead they receive portions of the incentive fees earned by the firm, which are paid out (primarily) at the end of rolling three- and five-year periods.

The goal of long-term investing is to maximize sustained, long-term value growth for the ultimate benefit of all stakeholders. If major institutional investors shift the emphasis of their equity investing from short-term strategies to longer-term investing, we believe they can also influence corporations to shift their focus towards sustained longer-term performance. Given these goals, evaluating the performance of a long-term investment approach requires a departure from typical assessments of short-term price performance relative to standard benchmarks or peer rankings. In turn, incentive structures require recalibration to align fully with the long-term objectives of asset owners and beneficiaries.

Idea in action: Incentivizing long-term behaviors and performance at asset managers

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

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

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

5 Investment mandates

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

In this section, we build on the various action areas discussed in the previous sections of this paper. Asset owners typically use the term "mandate" to denote a contract with an asset manager that outlines basic investment guidelines, the terms and conditions of engagement, the fee structure and possibly the assigned benchmark. Mandates describe the playing field as well as the rules and the rewards of the game. They are the primary formal tool to mitigate principal-agent problems that may arise between asset owners and managers. The goal is to set out clear and reasonable short- and long-term expectations for both parties. To focus asset managers on long-term performance, mandates must go well beyond the typical legalistic contract to be a mutual fiduciary commitment that explicitly outlines the intended relationship between the asset owner and asset manager. Ideally, the mandate should clarify the asset owner's expectations for the strategy, and the asset manager's investment philosophy and approach.

Regardless of whether portfolio management is internal or external, asset owners should adopt the same basic principles when developing mandates:

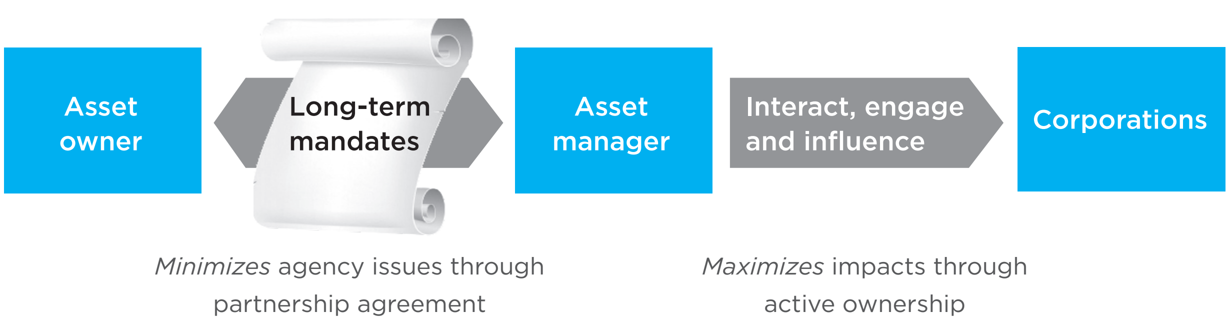
- Sufficiently aligned investment philosophies and risk tolerances of both the asset owner and asset manager should form the foundation for the long-term mandate
- The investment strategy for the long-term mandate should build on this foundation, be well defined and go beyond "beating benchmark X"
- The mandate should formalize a partnership commitment between asset owner and asset manager to execute the long-term strategy on a pre-discussed and pre-agreed basis
- The mandate should be designed to help mitigate behavioral biases by both asset owner and manager which too often interfere with long-term investing
- Finally, the mandate should provide the asset owner with an enforceable set of measures with which to assess the asset manager

Mandates should describe a number of distinct quantitative parameters and also emphasize qualitative factors, including:

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

Qualitative
enterprise culture; manager succession planning; expected nature and level of the asset manager's interaction with investee companies

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



Portfolio managers should assess investee companies using consistent operational and governance metrics. When discussing business decisions with investee companies, asset managers should adopt a practical business owner mindset, recognizing their limitations as outsiders but sufficiently well briefed on long-term corporate issues to be constructive. It is time for each and every one of us to act and make a difference, one mandate at a time. Information on how institutional investors can adopt a business owner mindset and better align with corporations can be found in "*Straight talk for the long term: A detailed look at improving the investor-corporate dialogue*," FCLT, March 2015, on **www.fclt.org**.

To align the interests of asset owner and asset manager on long-term value creation, mandates should provide clarity on four main topics, each of which we discuss in depth:

1. Investment philosophy and strategy
    1.1. Definition and outline of investment beliefs and risk appetite
    1.2. Outline of comprehensive investment strategy
    1.3. Level of interaction with and influence over investee companies
2. Investment process
    2.1. Clarity and robustness of investment process
    2.2. Investment selection (criteria, comparative opportunities and decision-making)
    2.3. Portfolio construction (security weighting and sector/factor diversification)
    2.4. Investment monitoring and disinvestment/divestment/replacement
    2.5. Engagement with investee companies
3. Investment and risk guidelines
    3.1. Risk definition, nature, metrics and management
    3.2. Asset turnover ratio
    3.3. Concentration limits
4. Terms and operations
    4.1. Benchmark choice(s) and purposes
    4.2. Fee/compensation structure
    4.3. Definition of success
    4.4. Other conditions (for example, lock-ups, redemptions, clawbacks, "skin in the game" and so on)

1. Investment philosophy and strategy

1.1. Investment beliefs and risk appetite

As highlighted earlier in this paper, investment beliefs are tenets and principles based on conviction and fact that define an institution's views on markets, investing objectives, values and strengths. Having a clear set of investment beliefs provides institutional investors with a powerful lens to consistently assess investment strategies.

A risk appetite statement that is referred to in the mandate sets the overall tone for the organization's approach to risk. It articulates motivations for risk-taking and provides a rationale for mitigating or avoiding certain types of risks. An organization's risk appetite statement provides a view on what risk means to the organization and how it should be measured and monitored.

Investment beliefs and risk appetite statements help asset owners and managers create mutually beneficial investment strategies.

1.2. Investment strategy

Long-term mandates need to articulate a clear comprehensive investment strategy—a concrete and detailed plan for investing in a sustainable and consistent manner in order to achieve predefined investment objectives. The investment strategy details how the investment philosophy and risk tolerance can be realized through a compatible, tested and proven methodology of procedures, rules and behaviors. All too often, investment strategy statements simply reference specific benchmarks. In contrast, a comprehensive strategy statement should clearly explain how the investment objective will be achieved, which approach will be prioritized and why, based on what parameters, and under which market scenarios and time frames. Some key descriptive elements for a long-term investment strategy include: definition of "long term" and investment horizon; strategy drivers and investment methodology; valuation and selection basis; and research approach, depth and metrics.

> *"… The Global Quality Equity Portfolio strategy attempts to exploit market opportunities represented by high quality securities with sound and stable fundamentals that exhibit higher risk adjusted returns over the long term. These opportunities arise from market behavioral biases which tend to extrapolate recent trends. By focusing on companies with strong and steady fundamentals, it is possible to avoid these biases and therefore generate better risk adjusted returns over the long run. Research work focuses on rigorous fundamental analysis to adequately assess the value and sustainability of companies' business models. This strategy is not based on internal teams' ability to predict future market trends. The strategy relies on a longer time horizon in order to benefit from mean-reversion effect …" — CDPQ*

1.3. Level of interaction with and influence over investee companies

Successful long-term investing requires focus, patience, and depth of analysis. To achieve this, we believe long-term investors should engage with investee companies at a deeper level than simply "voting with their feet." At a minimum, asset owners and managers should exercise their shareholder rights appropriately. Beyond voting, there is a spectrum of ways in which asset owners and managers can meaningfully engage with investee companies based on their equity investments in the companies. At lower levels of ownership, engagement normally takes the form of monitoring and coalition building. As their equity stake rises, investors may start acting like owners, often with board representation. An investor with a passive long-only investment strategy should actively exercise voting rights, yet otherwise may have quite limited engagement with investee companies because of small ownership positions. By contrast, an investor with an active concentrated portfolio might engage directly with company management and board members on a periodic basis and make proactive recommendations.

Ownership stake in company		
< 2%	1-5%	>10%
Ongoing engagement	**Active ownership**	**Relationship investing**
• Continuously monitors companies, with a mix of active and reactive engagement • May build microcoalitions with other investors • Often does not pursue any additional investment beyond an index-weighted holding	• Owns a meaningful position in a handful of companies • Usually remains below the 5% threshold for public disclosure of holdings • Tries to build microcoalitions with other investors • Works publicly or privately to persuade the board and management to change long-term strategy	• Takes a significant minority ownership • Often has board seat(s) • Works collaboratively with management on long-term strategy

Source: McKinsey & Company and Canada Pension Plan Investment Board

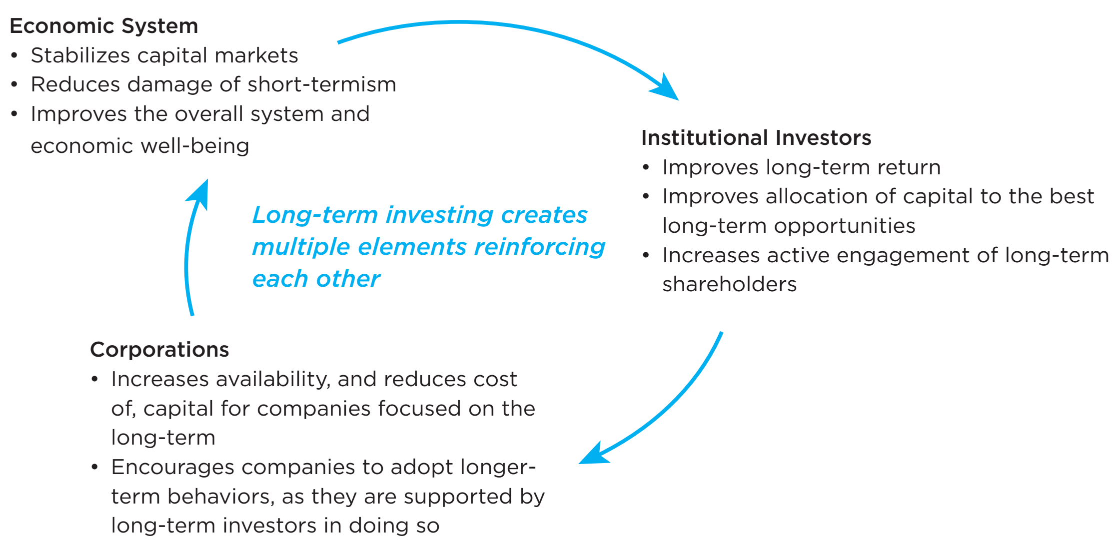
When investing on a longer horizon, asset managers can enhance their overall understanding of corporate strategy and performance of investee companies by changing focus:

- **Information requested:** From mostly financial and short-term (for example, quarterly EPS) to longer-term and more strategic (for example, market segment/share goals, five-year capex plan; leadership review)
- **Frequency and nature of interaction:** From short and frequent (for example, quarterly analyst calls) to longer and more in-depth (for example, annual half-day management meetings)
- **Level of interaction:** From mostly investor relations to a broader set of stakeholders (for example, management, board members, clients)

See *"Straight talk for the long term: A detailed look at improving the investor-corporate dialogue,"* FCLT, March 2015, on **www.fclt.org** for further discussion.

Such ongoing interactions can help asset managers favorably influence the long-term behavior of companies in which they invest. We define this influence as the asset manager's ability to effect positive, meaningful change in the behavior, priorities and focus of their investee company's management and board towards successful long-term value creation. We believe this influence can yield higher and more sustainable returns, better capital allocation across corporations, and improved economies, thus unlocking the virtuous circle of long-term investing.

The virtuous circle of long-term investing



Asset managers can use various levers to influence investee companies. The effectiveness of the levers will typically depend on the degree of influence (that is, ownership stake) that asset managers have on investee companies. At a minimum, we recommend that asset owners (or managers on their behalf) engage with investee companies through full exercise of their voting powers, with advance notification of their position on critical issues.

Asset manager levers	Impact on investee companies
1. Buy and sell equity	Equity transactions and holding periods influence how corporate managers interpret investor support.
2. Proxy and direct voting	By fully exercising their voting rights, asset owners (or asset managers acting on their behalf) demonstrate at least a minimal level of interest and involvement in the investee company.
3. Information inquiries	Direct information inquiries from asset managers are a strong signal for investee companies because they indicate the types of information that are important to investors. These signals can help company management adjust focus and choose more appropriate performance metrics, since what gets measured gets managed.
4. Dialogue	By engaging consistently over a long period with management via meetings or conference calls, investors signal their interest and dedication to the company's success. Investors can influence investee priorities by changing the nature and/or depth of dialogue.
5. Proposals and initiatives	Official or unofficial proposals for improvement by investors (individually or collectively) can influence certain investee decisions and draw management attention to particular issues. Sparingly and carefully used, public proposals can be powerful in catalyzing corporate change, especially when made in collaboration with like-minded investors.
6. Active role	Typically exercised through a board seat, allowing the investor to exert direct influence from within the company. This makes the investor directly involved in corporate affairs and reassures the investee company about the investor's commitment and intentions.
7. Significant/controlling interest	By acquiring a significant or controlling holding in an investee company, the investor makes a clear statement regarding its future involvement with the company.

2. Investment process

Key questions to consider when developing a sound long-term investment process:

- What methodology is being used to assess the investment opportunity?
- What are the primary and subsequent investment criteria to measure the suitability of assets for investment?
- What are the different steps in the asset selection process?
- How and when is the portfolio impact considered within the asset selection and weighting process?
- How are decisions being made? What are the relevant approval processes and limits?
- What are the sources of information used and what is their reliability and viability?
- What triggers the sale of an investment opportunity, what is the exit process, and how are replacements determined?
- How is decision-making success reviewed, evaluated and learned from? How will the asset manager interact with and potentially influence investee companies?
- Is there a robust process to help identify prospective investment opportunities through engagement with stakeholders, management and boards?

2.1. Clarity and robustness

The success of an investment strategy depends in part on the clarity and robustness of the investment process. These can be assessed based on relevant documentation that the asset manager creates to reflect its investment strategies, processes and decisions, providing evidence on:

- direction, idea-generation and testing, and quality and depth of research
- past effectiveness, measured by success rate and relative sizes of wins and losses, and sustainability of the investment strategy as determined by forward-looking scenarios or simulations.

The investment process is a critical aspect of a long-term mandate. While asset managers cannot predict or control the future, they can control (and asset owners can evaluate) their investment processes. A clear and sound investment process increases the likelihood of a successful investment outcome.

	Good outcome	Bad outcome
Good process	Deserved success	Bad break
Bad process	Dumb luck	Poetic justice

Source: J. Edward Russo and Paul J. H. Schoemaker, *Winning Decisions: Getting It Right the First Time*, first edition, New York, NY: Doubleday, 2002.

2.2. Investment selection

A sound investment process should include specific parameters and criteria for assessing and selecting opportunities. By incorporating details about desired portfolio characteristics in the long-term mandate, the asset owner can better understand how and where the asset manager creates value.

2.3. Portfolio construction

The weights of individual securities in a portfolio are almost as important to performance as the selections themselves. Both security selection and sector/factor weighting must be combined to ensure that underlying portfolio diversification is sufficient, and that the risk of exposures to common factors affecting many securities in the portfolio is recognized and prudently managed. The mandate should include an outline of how the asset manager will address the issue of control over portfolio construction and attendant risks.

2.4. Investment monitoring and disinvestment/divestment/replacement process

Asset managers are responsible for monitoring investee companies to ensure that (1) they continue to fit the overall investment strategy and (2) there are no clearly better long-term alternatives among comparable companies. In the long-term mandate, the asset manager should clearly describe the nature, parameters and frequency of the monitoring process. Often overlooked, the process of selling or trimming is as important in portfolio management as that of buying. And sales must include consideration of replacement holdings, although this should not be automatic and must be justified by the process disciplines. The mandate should thus also identify triggers and processes for disinvestment/divestment/replacement. Indeed, if investing is the process of "planting seeds," disinvesting/divesting is one of "collecting the fruits of one's efforts."

2.5. Engagement with investee companies

A sound long-term investing process should include engagement with a wide range of prospective investee companies. Asset managers should apply their documented investment criteria to continuously maintain a pool of potential investee companies. Asset managers can then identify a subset of preferred candidates for further analysis.

3. Investment and risk guidelines

Investment and risk guidelines provide a rule-based framework for managing investment portfolios. Typical guidelines address: risk definition, nature and metrics; expected average turnover of holdings and transaction costs; concentration risk limits (by issuer, geography, type of investment, and so on); authorized investment vehicles and limits; usage of financial leverage; risk management framework and limits; liquidity risk management and cash limits; and currency risk.

3.1. Risk definition, nature, metrics and management

Performance objectives are typically easy to state and track. Risk is a more complex topic that requires clear and measurable definitions, targets and metrics. Both risk and risk tolerance are influenced by the time horizon across which investing decisions are made. For instance, a 20-year time frame should address so-called deep risks, including depression and deflation risk. A five- to ten-year time frame would typically focus more on fundamental and valuation risk, including the risk that cash flow streams will be different than anticipated and the risk of paying too much for a stream of projected cash flows. However, over a three- to five-year time frame, or even shorter, one might be increasingly preoccupied by market perception and near-term price changes of a given investment.

While volatility is often used as a measure of risk, we believe that alternative measures of risk (for example, permanent impairment of capital, downside volatility, value at risk, and so on) should be considered to better reflect the long-term nature and horizon of the intended investment (see *risk appetite statement* section). Where applicable, asset owners should also consider the liability structures of their beneficiaries when defining and measuring risk.

> *"… From a risk perspective, it is quite different to be benchmark-driven than to be benchmark-agnostic. Indeed, we prefer to focus on and measure what we own rather than what we do not own (that is, what happens relative to the benchmark) as we believe such a benchmark-agnostic approach favors deep analysis and strong long-term convictions …"* — CDPQ

3.2. Asset turnover ratio

> *"Critics have long said that managers who buy and sell frequently are confusing motion with progress."* — Ian McDonald, *The Wall Street Journal,* August 12, 2005

The asset turnover ratio is the percentage of the investment portfolio's holdings that have been replaced with other holdings in a given year. It describes trading frequency and can also be expressed in years as an average holding period.

Generally, long-term mandates will exhibit lower asset turnover ratios than traditional investment portfolios. Long-term asset owners tend to behave more like business owners in the sense that they prioritize growth, stability and value creation over trading for price gains. The investment mandate should specify a low expected asset turnover ratio to confirm that the asset manager has a long-term mindset. For example, in their Global Quality Equity Portfolio, CDPQ aims to maintain an average turnover ratio of below 20 percent (significantly lower asset turnover than other portfolios). Even though subsequent turnover will often vary widely from year to year, its average over multiple years will provide an indication of consistency of outcome versus expectation.

3.3. Concentration limits

Concentration risk is the probability of loss arising from heavily lopsided exposure to a particular group of companies. Asset managers should monitor potential concentration risk by region or country, sector, type of investment and credit rating. A focused investing approach based on in-depth analysis often limits an asset manager's capacity to cover a large set of companies. Hence, long-term mandates are typically, but not always, characterized by higher levels of concentration. In order to address this nuance, asset owners should define risk guidelines and metrics that outline appropriate concentration limits to address the higher levels of concentration typically found in long-term mandates. Also, cash limits should permit some degree of patience in waiting for high quality companies to become available at appropriate pricing.

4. Terms and operations

4.1. Benchmark description and purpose

In a long-term mandate, the choice of benchmark and its associated purpose have material implications for how the investment strategy is defined and measured. Therefore, the benchmark and its purpose should be articulation in the mandate.

As noted earlier in the *benchmarking process* section, we believe benchmarks should be used at two distinct levels:

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

Strategy benchmarks assess whether or not the investment strategy has created long-term value. Execution benchmarks quantify how well the asset manager has executed the investment strategy. If the mandate is clear, the asset owner and asset manager are sufficiently aligned, and the true evaluation horizon is sufficiently long (at least five years), the asset owner and asset manager may agree to waive the execution benchmark and instead use a strategy benchmark for both purposes.

Both the strategy and execution benchmarks should be reviewed ex-post over multiple periods and evaluated in conjunction with other metrics. Since asset managers cannot always control performance against a benchmark due to external factors, it is important to evaluate performance using multiple metrics. By contrast, managers can control and enhance areas such as talent management, risk management, portfolio construction, and their investment processes.

4.2. Fee/compensation structure

Fee/compensation structure is a key lever to align asset owners and managers towards long-term investing. Effective compensation structures balance a number of elements, including time horizon, complexity, fixed management fees, performance-based payments, and payout conditions (see *evaluations and incentives* section for more details).

Compensation could include elements such as:

- **Base management fees** – The primary purpose of management fees should be to cover the asset manager's operational expenses. Management fees should not be a significant source of profit. For example, management fees should be no more than 20 to 25 percent of expected overall fee compensation, a level that satisfies their intended purpose. However, they often run considerably higher than what would be sufficient for "keeping the lights on" and harvesting beta returns.
- **Performance fees** – We believe performance-based compensation schemes should align asset managers with asset owners, and where possible, we recommend that performance-based compensation be a significant part of total compensation. Compensation should not be solely based on performance in a single year. Instead, it should be earned over a longer time period, preferably five years, to cover the length of most market cycles and be closely aligned with the intended partnership duration and the long-term intent of the investment. When feasible, appropriate risk metrics should be used to assess incentive-based compensation that distinguishes skill from luck.
- **Maximum fee cap** – Fees should not exceed a certain percentage that is pre-agreed by the asset owner and manager.

- **Hurdle rate** – Asset owners and managers should agree on a minimum return level/hurdle, in line with the investment objectives and prospective risk-return profile, that needs to be achieved over (a) defined period(s) before performance fees are paid.
- **High-water mark provision** – Fees for negative performance should be accumulated and applied against subsequent fees for positive performance.

4.3. Definition of success

A long-term mandate needs to go beyond the traditional standard of beating a given benchmark. The mandate should also evaluate elements such as clarity and robustness of the investment process, strategic consistency, deviation from the stated investment strategy ("style drift"), and corporate governance and organizational developments at the asset management entity. Measuring long-term performance does not mean that periodic evaluations are unnecessary. Rather, it is about applying the right metrics at the right time. We believe that certain key success measures should be monitored frequently (monthly or quarterly – for example, style drift, performance attribution, quality of new transactions) and others less frequently (annually – for example: key person risk, change in client base, products and services offering, corporate governance); therefore the mandate should specify reporting frequencies for different metrics. However, we recommend that asset owners and managers perform a full assessment of key success measures for the mandate at least once a year.

Sample assessment criteria for asset managers include:

Process	People	Performance
• Robustness, consistency, adherence and stability over time • Continued viability of the investment strategy and its consistency with investing philosophy • Frequency, level and impact of engagement with investee companies • Regulatory reporting and compliance requirements	• Alignment of the internal compensation scheme • Corporate governance soundness and management quality • Enterprise culture and employee satisfaction levels • Succession planning for key personnel	• Returns, value added, downside exposure, and return/risk metrics, • Performance attribution (performance drivers and their stability and consistency with the strategy) • Compliance with investment and risk guidelines

4.4. Other conditions that may encourage longer-term behavior

Lock-ups and early redemption penalties

Lock-ups and/or early redemption penalties are intended to dissuade asset owners from early cash withdrawals and/or partnership termination. A lock-up period is a predetermined amount of time following an initial investment during which the asset owner is restricted from unwinding the partnership (except in the case of certain pre-agreed circumstances, such as change of control, key man risk,[52] and so on) and withdrawing funds. An early redemption penalty is a contract provision that financially penalizes the asset owner for exiting funds earlier than intended. For example, Cevian Capital, a privately held asset manager based in Europe, benefits from having approximately 85 percent of its capital committed to it for rolling periods of three or five years (15 percent of capital is subject to rolling lock-ups of one and two years, but any capital withdrawn during the initial one to two years incurs a redemption penalty, which is paid by the withdrawing party into the fund for the benefit of remaining shareholders).

There is no consensus among asset owners about the necessity or even utility of lock-ups as deterrents to being influenced by short-term behavioral biases. Both lock-ups and early redemption penalties are usually negotiated within a broader set of terms and parameters. Ideally, they help asset managers focus on long-term value creation by ensuring the availability of funds over a predetermined period. We recommend that asset owners form their own view of lock-ups and redemption penalties based on their own circumstances and beliefs.

Clawbacks

Clawback provisions require that asset managers return performance fees to asset owners if the fund's initial profits are followed by losses such that the overall investment is unprofitable over the entire investment period. These provisions are common in private equity.

"Skin in the game"

Fund managers are said to have "skin in the game" when they use their own money to invest in a given strategy. Although "skin in the game" provisions are uncommon in public markets, the existence of such a clause in a long-term mandate can stimulate a higher level of commitment by the fund manager, and by extension the portfolio manager, in the investments they make.

An exhaustive, sound and well-negotiated long-term mandate can help create positive outcomes for asset owners, asset managers and investee companies alike.

Mandates can help asset owners unlock the virtuous circle of long-term investing in two key ways:

1. by influencing asset managers to prioritize long-term investing
2. by indirectly enhancing the quality and effectiveness of investor influence over corporations

Potential impact of long-term mandates on asset owners and managers

Improved alignment and stronger partnership of asset owner and asset manager

- Consistency of investment horizon and philosophy between owners and managers
- Deeper mutual understanding
- Longer, more focused, and more productive partnerships

Defines a consistent, meaningful evaluation framework

- More exhaustive and appropriate set of evaluation metrics for the asset owner
- More focus on longer-term and non-financial metrics

More focused strategies

- Investment strategies that are less dependent on short-term market pricing and movement (that is, benchmark-independent, long-term value creation-oriented, non-market-based benchmarks)
- More concentrated portfolios, generally with lower turnover and lower costs
- Greater willingness and ability to influence investee companies

Better results

- Improved and more sustainable returns
- Better understanding of risks taken (and not taken)
- Less short-term performance volatility than traditional benchmarks (especially in more benchmark-agnostic type strategies)

Potential impact of long-term mandates on investee companies

More productive interaction between asset managers and investee companies
- Deeper, broader and higher quality interactions
- Increased focus on strategic and nonfinancial metrics
- Increased level of influence of core shareholders

More stable shareholder base for the investee companies
- Lower turnover of core shareholders
- Better capital allocation and long-term value creation

Ability/need to focus on long-term value creation by the investee companies
- Increased vision and transparency on medium- and long-term strategy
- Better understand and explain value creation drivers of the company

In order to see more long-term mandates develop in coming years, we believe that the following conditions will need to be in place:

- A strengthened belief among asset owners and asset managers in long-term mandates, and a greater commitment of assets and expertise to them
- Alignment of all stakeholders in the investment cycle on the benefits, conditions, and implications of having long-term mandates
- An increased level of trust and partnership between asset owners and asset managers
- Experienced people on both sides of the relationship
- Investee companies and asset managers willing to deepen their relationships with each other

Conclusion

Modern financial markets and media attention tend to incentivize corporate managers to take steps that boost asset prices in the near term, rather than steps that create long-term corporate value and health. In textbook settings characterized by perfect information and the absence of behavioral biases on the part of investors, we would expect the benefits of long-term corporate strategies to be reflected accurately in current share prices. However, the evidence suggests that market pricing failures are both numerous and substantial. As a result, today's asset prices do not always reflect long-term asset values.[53] Since too many investors focus on the short term, small news items with little information content can have outsized implications for asset prices and for market volatility more generally. This relentless focus on short-term results is self-defeating because it "undermines corporate investment, holds back economic growth, and lowers returns for savers."[54]

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

While long-term investors have the ability to invest over longer time horizons, we recognize that they should not completely ignore short-term opportunities. As appropriate to meet the needs of their beneficiaries, investors need to optimally balance their overall portfolio across a mix of short-, medium-, and long-term strategies. Nevertheless, we believe there is a clear need to shift the focus of public equity investing away from its current heavy emphasis on predicting short-term stock price movements. We believe that investors and businesses alike can create greater and more sustained value by adopting strategies that harvest the fruits of long-term earnings growth[55] and benefit savers, beneficiaries, capital markets, and economies.

Appendix

Appendix A: The investment value chain and fiduciary duty

The relationships between savers, asset owners, asset managers, corporate boards, and corporate management form the key linkages in the investment value chain.

The Investment Value Chain

Individual savers
directly or indirectly invest savings into financial markets

...and ultimately realize returns from the net cash received on their indirect or direct investments in corporations.

Institutional investors (IIs)

Asset owners
are trusted to steward the vast majority of individual savers' capital to realize the desired returns.

Includes: pension funds, insurance companies, sovereign wealth funds, endowment funds, mutual funds

Asset managers
are appointed by Asset Owners to invest capital in corporations

Includes: internal portfolio managers at asset owners, appointed external investment management firms, and hedge or other investment funds

Corporations

Corporate boards
are responsible to oversee how this capital is directed by management and to fulfill a fiduciary duty to serve the best interests of the company

Management
operate businesses for profit and to develop a sustainable competitive advantage....

... to in turn provide returns to investors

Government and regulators
create the legislated framework within which all participants interact

Observers
through their opinions, counsel and/or actions influence the main value chain participants.

Includes: media, proxy advisory firms, investment consultants, sell-side analysts

Source: McKinsey & Co. and Canada Pension Plan Investment Board

Note: This is a simplified illustration of the investment value chain. It does not necessarily account for all activities along the value chain. For example, the dominance of the secondary market limits the direct leverage that a specific investor has over a company.

In their HBR article, Barton and Wiseman note that there is no universal definition of fiduciary duty. In the context of corporate boards, however, "most legal codes stress at least two core notions embedded in this duty: loyalty (the notion of placing the company's interests ahead of one's own) and prudence (applying proper care, skill and diligence to business decisions)."[56] Corporate boards thus have a fiduciary duty to promote the long-term viability of the company itself, rather simply generating value for its current shareholders.[57]

Asset owners have similar fiduciary duties of loyalty and prudence to their beneficiaries, who include savers and future generations. Asset managers have a fiduciary duty to their clients (that is, asset owners) and ultimately to savers. In the context of investing fiduciary assets, "fiduciary duty is a process-oriented standard that guides rather than dictates investment decisions ... the duty of impartiality, which is part of the duty of loyalty, requires that fiduciaries balance short-term and long-term considerations."[58]

Companies significantly undervalue and under-invest in longer-term prospects.[59] The problem is only exacerbated by 24-hour business news cycles focused on minute-by-minute stock price fluctuations. Thus public companies stand to benefit from having a secure base of engaged shareholders.[60] Knowing that their primary shareholders have the ability to stay the course when times get tough, companies can focus on defining and executing strategies for the long term, including due emphasis on environmental, social and governance (ESG) issues.[61] Companies must develop stable, mutually beneficial relationships with customers, employees, suppliers, regulators and government. A long-term investment relationship allows for deeper and more meaningful dialogue between owners of capital and corporations, ensuring better alignment in their goals and enhancing the stability of financial markets (see "*Straight talk for the long term: A detailed look at improving the investor-corporate dialogue*," FCLT, March 2015, on www.fclt.org).

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[2] Dominic Barton and Mark Wiseman, "Focusing Capital on the Long Term," *Harvard Business Review*, January–February 2014, Volume 92, Number1/2, pp. 44-51. **hbr.org**.

[3] Keith Ambachtsheer and John McLaughlin, "How effective is pension fund governance today? and Do pension funds invest for the long term? Findings from a new survey," 2015, **kpa-advisory.com**. The survey included 81 respondents from sovereign-wealth funds, public pension plans, corporate pension plans, etc. 54 were CEOs, CIOs, Executive or Managing Directors and the remaining 27 were senior executives. The survey respondents were global with 23 Canadian, 22 European, 25 U.S. and 11 Asian, Australian and New Zealand funds represented.

[4] Institutional investors (both asset owners and asset managers) directly or indirectly own 73% of outstanding stock in the largest 1,000 U.S. public corporations. See Matteo Tonello and Stephan R. Rabimov, "The 2010 Institutional Investment Report: Trends in Asset Allocation and Portfolio Composition." The Conference Board Research Report, No. R-1468-10-RR, 2010, **ssrn.com**.

According to the McKinsey Global Institute, institutional investors own more than a quarter of all financial assets worldwide. These assets currently total USD $200 trillion, including equities, bonds and other fixed-income securities, cash and bank deposits, and alternative assets. See *The emerging equity gap: Growth and stability in the new investor landscape*, McKinsey Global Institute, December 2011, **mckinsey.com**.

[5] See Serdar Çelik and Mats Isaksson, "Institutional Investors as Owners: Who Are They and What Do They Do?," OECD Corporate Governance Working Papers, Number 11, December 2013, **oecd.org**. While short-termism may also exist in private companies, we believe it is less prevalent. In fact, long-term orientation is often cited as a major advantage of private companies. For example, see Michael Dell, "Going Private Is Paying Off for Dell," *The Wall Street Journal*, November 25, 2014, **wsj.com** and Whitney MacMillan and Greg Page, "Generational thinking at Cargill" in *Perspectives on the Long Term*, FCLT, 2015, **fclt.org**. As a result, we do not place particular focus on this asset class. Nor do we focus on asset classes such as real estate, infrastructure, timberland and agriculture that yield inherently long-term payoffs.

[6] A number of initiatives (such as the OECD's project on institutional investors and long-term investment and the World Economic Forum's work on long-term investing) are focused on creating a regulatory environment conducive to long-term investing. See the World Economic Forum (**weforum.org**) and the Organisation for Economic Co-Operation and Development (**oecd.org**). Similarly, initiatives such as the Canadian Coalition for Good Governance (**ccgg.ca**), the stewardship codes of the UK and Japan (**frc.org.uk** and **fsa.go.jp**), the Asian Corporate Governance Association (**acga-asia.org**) and others, address the importance of sound governance for institutional viability, long-term value creation, and the functioning of the financial markets more generally.

[7] See *The Top Ten: Investing for Canada on the World Stage*, Boston Consulting Group, 2013, **cppib.com** and "Maple revolutionaries – Canada's public pension funds are changing the deal-making landscape", Economist, March 3, 2012, **economist.com**.

[8] We use the terms "institutional investors" and "investors" interchangeably throughout the paper.

[9] There are numerous other definitions of long-term investors and long-term investing. For some examples, see Adrian Orr "The rise and rise of sovereign wealth funds: Long-term investing" speech to the Trans-Tasman Business Circle, October 2013, **nzsuperfund.co.nz**; Andrew Ang and Knut N. Kjaer, "Investing for the long run," chapter 4 in *Asset Management: A Systematic Approach to Factor Investing*, first edition, New York: Oxford University Press, 2014; David Denison, "What it means to be a long-term investor," speech at the Conference Board of Canada & Towers Watson Summit on the Future of Pensions, Toronto, April 13, 2010, **cppib.com**; *G20/OECD High-Level Principles of Long-Term Investment Financing by Institutional Investors*, Organisation for Economic Co-Operation and Development, September 2013, **oecd.org**; and *The Future of Long-term Investing*, World Economic Forum USA,2011, **weforum.org**.

[10] See Keith Ambachtsheer,"The Case for Long-Termism," *Rotman International Journal of Pension Management*, Volume 7, Number 2, 2014, **ssrn.com**.

[11] In 2012 *Pensions and Investments* magazine and Oxford University surveyed 685 asset owners, asset managers and investment consultants, in roughly equal numbers, on their long-term investment beliefs. A little more than half of the respondents said that their institutions published investment beliefs, or otherwise held them in some official capacity. Irrespective of institutionally agreed-on beliefs, 87 percent of respondents indicated that they held and used beliefs informally to guide their decisions See *P&I/Oxford University Investment Beliefs Survey Results*, Pension and Investments, 2012, **pionline.com**.

[12] See Donald M. Raymond, "Investment Beliefs" in *Handbook of Finance, Volume 2, Investment Management and Financial Management, first edition*, Hoboken, NJ: John Wiley & Sons, Inc., 2008

[13] See, for example, Shlomo Benartzi and Richard H. Thaler, "Myopic Loss Aversion and the Equity Premium Puzzle" *The Quarterly Journal of Economics*, 1995, Volume 110, Number 1, pp. 73-92.

[14] David Iverson, "Investment Beliefs" in *Strategic Risk Management: A Practical Guide to Portfolio Risk Management*, first edition, Chicester, UK: John Wiley & Sons Ltd., 2013.

[15] The principal-agent problem in the provision of financial services gives rise to the classic issue of adverse selection: firms that pay closer attention to principals' interests may generate lower returns on horizons over which performance is typically measured. This conservatism may cause them to lose new business if clients base their investment decisions on recent past performance.

[16] The academic literature suggests that markets go through boom and bust cycles, which is corroborated by NZSF's investment experience. The fund's internal modeling supplemented this with the finding that tilting performed no worse over the long run than a static asset-allocation strategy.

[17] See Sue Brake, Aaron Drew, and David Iverson, *Governance, investment beliefs and dynamic asset allocation*, Guardians of New Zealand Superannuation, New Zealand Superannuation Fund, November 15, 2009, **nzsuperfund.co.nz**.

[18] Jack Gray, "Rethinking Investment Beliefs in a Time of Crisis: The Calming Hand of Philosophy," *Rotman International Journal of Pension Management*, 2009, Volume 2, Number 1, **ssrn.com**.

[19] Jaap van Dam, "Rethinking Investing from the Ground Up: How PFZW and PGGM are Meeting this Challenge," *Rotman International Journal of Pension Management*, 2014, Volume 7, Number 1, **ssrn.com**.

[20] It is useful to distinguish between beliefs and facts as New Zealand Superannuation Fund does. See New Zealand Superannuation Fund, Investment Beliefs, October 2014, **www.nzsuperfund.co.nz**.

[21] Shlomo Benartzi and Richard H. Thaler, "Myopic Loss Aversion and the Equity Premium Puzzle" *The Quarterly Journal of Economics*, 1995, Volume 110, Number 1, pp. 73-92.

[22] Some studies have attributed this predictability to the tendency of stock market prices to overreact. De Bondt and Thaler (1985), for example, argue that investors are subject to waves of optimism and pessimism that cause prices to deviate systematically from their fundamental values and later to exhibit mean reversion. See Werner F.M. De Bondt and Richard H. Thaler. "Does the Stock Market Overreact?," *Journal of Finance*, 1985, Volume 40, Issue 3, pp. 793-805. In 1994, M. Kurz explained excess market volatility by investors holding rational "beliefs" rather than rational expectations, and that these beliefs undergo periods of correlation leading to extremes. See Mordecai Kurz "On Rational Belief Equilibria" *Economic Theory*, 1994, Volume 4, pp. 859-76, **stanford.edu**.

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[26] See Geoff Warren, *Long-term Investing – An Institutional Investor Perspective*, Research Report Centre for International Finance and Regulation and FutureFund, October 2014, **cifr.edu** and Brad Jones, *Navigating the Long Run: A Strategic Asset Allocation Framework for Pensions, Insurers, Endowments and Sovereign Wealth Funds*, Deutsche Bank Special Report, February 2012.

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[28] See *Sustainable Investing Establishing Long-Term Value and Performance*, DB Climate Change Advisors, June 2012, **deutscheawm.com**.

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[30] See *Our Investment Beliefs*, Ontario Teachers' Pension Plan, 2015, **otpp.com**.

[31] See *WSIB Investment Beliefs*, Washington State Investment Board, 2015, **sib.wa.gov**.

[32] *Management Report*, Caisse de dépôt et placement du Québec, 2013, **lacaisse.com**, and *Our Clients, the Depositors*, Caisse de dépôt et placement du Québec, 2013, **lacaisse.com**.

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

We understand that when assessing a new strategy, mandate or manager for appointment, five years of data may not always be available. In such cases, asset owners should make a judgment to select based on their investment belief and/or rationale.

[35] For example, a major sovereign-wealth fund's investment groups define risk as the permanent impairment of capital rather than return volatility or tracking error relative to benchmarks. For long-term equity portfolios, it believes that businesses that have strong moats, operational excellence and sustainably superior long-term returns tend to exhibit lower capital impairment risks. This approach to risk excludes conventional risk-adjusted performance measures such as the Sharpe ratio, the information ratio or M2 (Modigliani risk-adjusted performance). All these measures are typically based on the volatility of monthly returns relative to the appropriate benchmark. Because the short-term volatility of security prices typically does not affect the underlying intrinsic value of the security (although it affects its market price), we believe they are not relevant measures of risk for a long-term investment strategy. See William Kinlaw, Mark Kritzman and David Turkington, (2014) "The Divergence of High- and Low-Frequency Estimation: The Implications for Performance Measurement," MIT Sloan Research paper 5110-14.

[36] *MSCI launches innovative family of low carbon indexes*, MSCI, September 16, 2014, **msci.com**.

[37] Only over the long term does the change in share price of a company reflect its underlying earnings power. See Gordon Pepper, *Money, Credit and Asset Prices,* first edition, Basingstoke, UK: Palgrave Macmillan, 1994.

[38] William F. Sharpe, "Risk, market sensitivity, and diversification," *Financial Analysts Journal*, January–February 1995, Volume 51, Number 1, pp. 84–8, cfapubs.org.

[39] The index could include a smaller subset of innovative companies that may not be profitable but are thought to have sustainable growth potential.

[40] Using the logarithm of market cap rather than size itself is one way to reduce the dominance of market cap in weightings.

[41] Paul Gompers, Joy Ishii and Andrew Metrick, "Corporate Governance and Equity Prices," *The Quarterly Journal of Economics*, February 2003, Volume 118, Number 1, pp. 107-155.

[42] For a comprehensive look at suggestions for how boards can be better focused on the long term, see Dominic Barton and Mark Wiseman, "Where Boards Fall Short," *Harvard Business Review*, January–February 2015, Volume 93, Number 1/2, pp. 98-104, **hbr.org**.

[43] See *JPX-Nikkei Index 400 Factsheet*, JPX-Nikkei 400, 2015, **indexes.nikkei.co.jp** and Ben McLannahan, "Japan groups take a shine to JPX-Nikkei 400 index," *Financial Times*, June 15, 2014, **ft.com**.

[44] See Amit Goyal and Sunil Wahal, "The selection and termination of investment management firms by plan sponsors," *Journal of Finance*, August 2008, Volume 63, Number 4, **cfapubs.org**; and Karen Dolan, "Who Are Fickler Investors: Advisors, Institutions or Individuals?," *Morningstar*, June 10, 2010, **morningstar.com**.

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

[46] See Suzanne L. Duncan et al., *The Folklore of Finance: How Beliefs and Behaviors Sabotage Success in the Investment Management Industry*, December 2014, State Street Center for Applied Research, **statestreet.com**.

[47] See David L. Donoho, Robert A. Crenian, and Matthew H. Scanlan, "Is patience a virtue? The unsentimental case for the long view in evaluating returns," *Journal of Portfolio Management*, Fall 2010, Volume 37, Number 1, pp. 105-120, iijournals.com. The authors use a Monte Carlo simulation of 10,000 investment managers to show that institutions that rely on longer performance horizons of more than five years are more likely to select and stay with better managers than institutions that use shorter performance horizons.

[48] Benjamin Graham and David L. Dodd, *Security Analysis*, first edition, New York and London: The McGraw-Hill Companies, 1934.

[49] Given sufficient observations (at least 60 month, or perhaps rolling 36-months over a period of at least five years), the Sharpe Ratio could be used to assess this portfolio's performance in the context of the broader equity market and alternative asset classes. As long as the asset manager adds alpha through security choices, the portfolio's Sharpe Ratio will always exceed that of the comparable broad equity market index.

[50] Donald M. Raymond, "Paying (only) for skill (alpha): A practical approach," *CFA Institute Conference Proceedings Quarterly*, June 2008, Volume 25, Number 2, pp. 51-59, **cfapubs.org**.

[51] Amit Goyal and Sunil Wahal, "The selection and termination of investment management firms by plan sponsors," *Journal of Finance*, August 2008, Volume 63, Number 4, pp. 1805-1847, **cfapubs.org**.

[52] Key man risk pertains to overreliance on key personnel for investment decisions from ideas generation, and security selection to portfolio construction.

[53] See Richard Shiller, *Irrational Exuberance*, second edition, Princeton, NJ: Princeton University Press, 2005.

[54] Dominic Barton and Mark Wiseman, "Focusing Capital on the Long Term," *Harvard Business Review*, January–February 2014, Volume 92, Number 1/2, pp. 44-51, **hbr.org**.

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

[56] Dominic Barton and Mark Wiseman, "Where Boards Fall Short." *Harvard Business Review*, January–February 2015, Volume 93, Number 1/2, pp. 98-104, **hbr.org**.

[57] See Lynn Stout, *The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations and the Public*, first edition, San Francisco, CA: Berrett-Koehler Publishers, Inc., 2012.

[58] James P. Hawley, Keith L. Johnson and Edward J. Waitzer, "Reclaiming Fiduciary Duty Balance," *Rotman International Journal of Pension Management*, Volume 4, Number 2, pp. 4-17, Fall 2011. **ssrn.com**.

[59] Andrew Haldane and Richard Davies, "The Short Long," a speech delivered at the 29th SUERF (Société Universitaire Européene de Recherches Financières) Colloquium in Brussels, May 2011, **bankofengland.co.uk**; and Shlomo Benartzi and Richard H. Thaler, "Myopic Loss Aversion and the Equity Premium Puzzle" *The Quarterly Journal of Economics*, 1995, Volume 110, Number 1, pp. 73-92.

[60] Jarrad Harford, Ambrus Kecskes and Sattar Mansi, "Do Long-Term Investors Improve Corporate Decision Making?," The Harvard Law School Forum on Corporate Governance and Financial Regulation, February 2015, **ssrn.com**.

[61] See Robert G. Eccles, Ioannis Ioannou and George Serafeim, "The Impact of Corporate Sustainability on Organizational Processes and Performance," NBER Working Paper No. 17950, March 2012, **nber.org**. Using a matched sample of 180 companies, the study finds that companies that voluntarily adopt environmental and social policies (high-sustainability companies) generally outperform companies that do not (low-sustainability companies) over the long term, both in terms of stock market and accounting performance.