Thinking Ahead Institute

Willis Towers Watson

“One person with a belief is equal to ninety-nine who have only interests.”

John Stuart Mill

Converting the 99

Long-horizon investing beliefs

Long-horizon investing working group

This document has been written by members of the Thinking Ahead Group 2.0 (Tim Hodgson, Roger Urwin, Liang Yin, Jeremy Spira) following the research and discussion conducted by the Thinking Ahead Institute's long-horizon investing working group. The authors are very grateful to the members of the working group for their input and guidance but stress that the authors alone are responsible for any errors of omission or commission in this paper.

While the key objective of the group is to deliver to Thinking Ahead Institute members a series of publications that form a holistic framework for practically implementing long-horizon investing, a secondary objective is to positively influence the investment industry outside the membership. We hope this paper serves both purposes.

The members of this working group are as follows:

- **Ciaran Barr**, RPMI Railpen
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Executive summary

- When John Stuart Mill said “One person with a belief is equal to ninety-nine who have only interests” he contrasted the power of those with an active conviction on an issue to those that give the issue more passive attention. In essence, beliefs can be used to bring greater rigour to thinking and problem solving.
- Very few universal investment “truths” have stood the test of time. In the absence of a solid theoretical foundation of truths or axioms, investors must rely on beliefs to guide portfolio decisions.
- Well-documented, smart and edgy long-horizon beliefs are foundational to good long-horizon investment thinking and this correlated ultimately with better investment outcomes.
- When developing investment beliefs, investors must recognise that each organisation is unique; absolute consensus about beliefs is not possible; and beliefs are only a starting place for investment decisions.
- Based on working group discussions and further research, we propose nine core long-horizon investing beliefs for investors to consider and adapt. We would not expect full adoption of all nine beliefs by an investment committee, but disagreement about a majority of them may signal that an investor is not ready to move to a long-horizon footing.

1. The competitive edge for long-horizon investors is determined by their ability (skillsets) to identify long-term opportunities and their willingness (mindset) to maintain their position in the face of short-term performance issues.
2. Long-horizon investing does not oblige investors to hold for long periods as new investment conditions and prices will support changes to long-horizon portfolios.
3. Long-horizon investing allows investors to enhance returns by accessing investment opportunities that are not available to short-horizon investors and by avoiding certain drags on investment returns that short-horizon investors incur.
4. Long-horizon investing creates greater societal value through a more effective, efficient and sustainable wealth creation process.
5. Long-horizon investors have the ability to develop long-term relationships with investee companies and to be active and engaged owners, through both active and index tracking holdings.
6. Systematically considering sustainability issues, including but not limited to ESG, will lead to more complete analyses and better-informed investment decisions.
7. Addressing the governance challenge of long-horizon investing requires a major shift of mindset and significantly expanded skillsets.
8. Long-horizon investing intensifies the difficulty of aligning agents (both internal and external) across the entire investment chain.
9. The quantitative measurement and qualitative assessment of internal and external asset managers should emphasise process, behaviours and consistency with long-term focus.

Introduction – investment truths in short supply

Are markets efficient? Are there universal truths, or mathematical formulae, that can guide our investment decisions?

"Human decisions affecting the future, whether personal or political or economic, cannot depend on strict mathematical expectation, since the basis for making such calculations does not exist."

JM Keynes, economist and investor

Keynes' assertion is apparently as true today as it was in 1936 when he wrote The General Theory of Employment, Interest and Money. There have been many proponents of efficient markets and many claims of successful mathematical investment systems, but none have been proven beyond doubt.

In a previous TAI publication[1] we argued that mainstream finance theory, with its orientation around a degree of market efficiency and rational expectations, provides little guidance to investment practice. In fact, mainstream finance theory can potentially take us in completely the wrong direction.

In the absence of a solid theoretical foundation, or a "universal truth", a strong and robust set of investment beliefs is needed if we are to make effective portfolio decisions within a complex and dynamic investment eco-system.

This paper explores why investors should expend time and effort in developing investment beliefs in the area of long-horizon investing, offers ideas on how beliefs can be developed, and suggests a rudimentary set of beliefs for long-horizon investing that might be a useful starting point for organisations in the development of their own beliefs.

[1] Stronger Investment Theory, Thinking Ahead Institute, 2016

Why investors need beliefs

"Investment theory and practice have evolved considerably over the last fifty years. Despite this there is no generally agreed objective framework for investors that adequately describes how to view capital markets, or how to apply these insights for investment purposes. Investment beliefs accept this reality and are established by investors to provide them with focus and assist effective decision making in a complex environment."

National Employment Savings Trust, UK

To the chagrin of the world's leading business schools, few universal investment "truths" have stood the test of time. Just as The Theory of Everything may forever elude physicists, so investing refuses to be tied down to a formula.

Instead of seeing the investment world as being machine-like that can yield to mathematical prediction, we postulate that financial markets are examples of complex systems (see Figure 1), where "the whole is greater than the sum of the parts".

The investment world is highly dynamic – its state a second ago is no longer its current state. Information constantly changes, and financial participants have differing levels of information and understanding and so act differently; they provide information to other participants – some of which is noise and some of which is signal – and so they, and other investors, will always be fallible and make mistakes given they have an incomplete view of what matters. These types of conditions create a certain type of market inefficiency not described in mainstream finance theory.

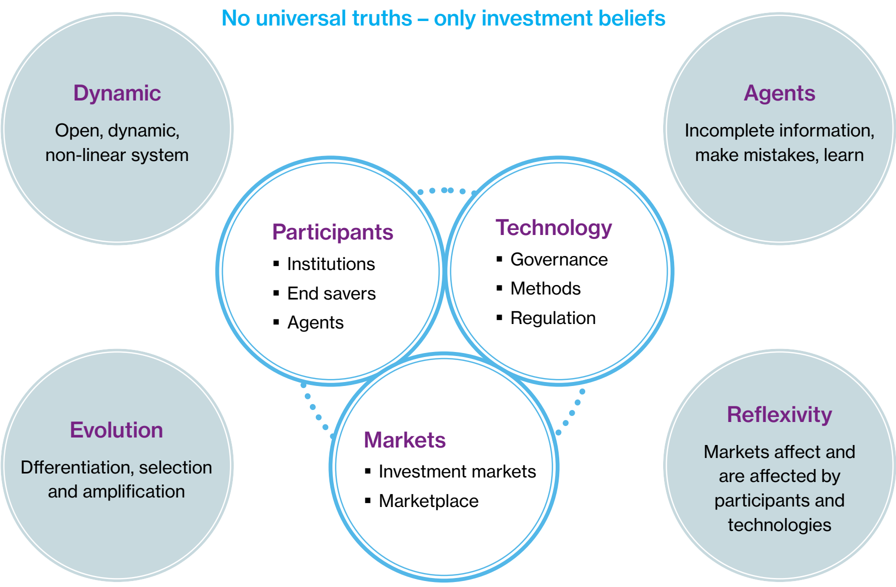
Further, this interconnectedness in investor beliefs and actions gives rise to the phenomenon of reflexivity, which not only means that fundamentals affect asset prices, but also that asset prices – through their impact on behaviours – can change the fundamentals.

Markets are consistently subject to external shocks from the spheres of technology, politics, regulation and, as the insurance industry would label it, Acts of God. Furthermore, investors react to these external shocks through the lens of their different beliefs resulting in the even more important role of internal (endogenous) risk in driving market fluctuations.

Speedy market evolution, often in a non-linear manner, compounded by a long time horizon, would render most, if not all, mathematical investment models irrelevant. A set of strong investment beliefs acts as a long-term compass to guide investment decisions in such an environment.

Beliefs are unique to each investor and must be developed over time, with reference to the needs of the investor and the investor's perception of the market environment. There is no textbook and no shortcuts to the creation of useful beliefs.

Figure 1: The investment world is a complex adaptive system



The benefits of beliefs

There is strong practical evidence that beliefs improve investment outcomes. First, studies, such as **Best-Practice Investment Management** by Clark and Urwin (2007) have highlighted the importance of investment beliefs within an overall governance framework.

Second, our work with investors has shown that having structured beliefs saves time (and resources) in the decision-making process. Beliefs help us to know when to act (and when not to). And they help us avoid mistakes by introducing rigour into the investment process (which is particularly useful in times of stress).

To harvest the long-term premium[2], a necessary first step in the investment process should be to develop a clearly articulated set of beliefs based on conviction and fact: without beliefs, you can argue there is no premium.

[2] "The search for a long-term premium", Thinking Ahead Institute, 2017

The process of building strong beliefs

Investment beliefs are high-level principles and subjective thinking that guide the investment organisation to certain types of decisions and content.

They normally encompass the full spectrum of investment issues: mission, goals, risk, time horizon, alpha, beta, smart beta, governance, sustainability and other areas. They should be broad in recognising multiple strands and deep in recognising complex investment features.

Effective investment beliefs are accurate, documented and validated and need to be consistently applied in the decision-making process at all levels. The best investment beliefs are smart (reflective of good insight) and edgy (reflective of competitive positioning).

The process (see Figure 2 for an example) of developing shared beliefs involves considering something inherently abstract ("soft") and codifying it in a clear and more tangible form ("hard").

Investment beliefs are inevitably subjective and as a result may differ across team members in the organisation. So achieving a level of alignment is one of the key criteria for success here; that is, the members of the organisation need to be aligned in supporting the adoption of certain beliefs. We suggest that in practice this is more about a settlement than a consensus.

Putting beliefs into action is the acid test of course. Good belief systems will be translated into actual strategies, polices and decisions. Using them in practice requires some discipline but the outcomes of aligned and actionable beliefs are more coherent decisions.

Figure 2: The beliefs process – an example

Process stage	Core tool or action	Outcomes
1. Survey at all levels	Primary Beliefs assessed based on single factors	▪ Conviction vectors
2. Develop beliefs into actionable beliefs	Working Beliefs developed by exec derived from Primary Beliefs	▪ Strawman Working Beliefs
3. Settle the Working Beliefs	Adopt socialising/settlement phase. Integrate with corporate values *Apply triage process**	▪ Final Working Beliefs
4. Map Working Beliefs to Policies to Portfolios	Map Working Beliefs into investment guidelines	▪ Principles and Policies Document ▪ Portfolios comply
5. Socialise more deeply	Socialise Beliefs and build out greater organisation-wide understanding	▪ Organisation-wide beliefs measured in associate engagement

**Triage Process. Test strawmen beliefs under independent Agree/Can Live With/Don't Agree choices Move to adopt belief if Agrees get 50% majority and Agrees + Can Live With's get 75% majority.*

The panel below presents a short case study of how CalPERS, a leading US pension fund, has strengthened its investment belief system and two of its core investment beliefs.

Investment beliefs – the approach used by CalPERS

- Ten core investment beliefs 'owned' by board and staff developed in highly intensive change process using strong alignment/socialising principles
- The core beliefs were succinct, the sub-beliefs were smart and edgy
- Investment theory is unsettled, so strong thinking and judgements were key
- Focus, coherence and time-efficiency are achieved in decisions which are complex, sensitive and have competing issues
- The framework also helps integrate different parts of governance – members of the board, the executive team as well as a variety of investment service providers
- In addition, it helps decisions to be subject to greater transparency for the benefit of beneficiaries and stakeholders
- CalPERS' focus on beliefs has resulted in particular attention on two hard-to-settle areas – risk and sustainability.

Core belief: a long time investment horizon is a responsibility and an advantage.

Sub-beliefs:

Long time horizon requires that CalPERS

- Consider the impact of its actions on future generations of members and taxpayers
- Encourage investee companies and external managers to consider the long-term impact of their actions
- Favor investment strategies that create long-term, sustainable value and recognize the critical importance of a strong and durable economy in the attainment of funding objectives
- Advocate for public policies that promote fair, orderly and effectively regulated capital markets.

Long time horizon enables CalPERS to:

- Invest in illiquid assets, provided an appropriate premium is earned for illiquidity risk
- Invest in opportunistic strategies, providing liquidity when the market is short of it
- Take advantage of factors that materialize slowly such as demographic trends
- Tolerate some volatility in asset values and returns, as long as sufficient liquidity is available.

Core belief: long-term value creation requires effective management of three forms of capital: financial, physical and human.

Sub-beliefs:

- Governance is the primary tool to align interests between CalPERS and managers of its capital, including investee companies and external managers
- Strong governance, along with effective management of environmental and human capital factors, increases the likelihood that companies will perform over the long-term and manage risk effectively
- CalPERS may engage investee companies and external managers on their governance and sustainability issues, including:
  - Governance practices, including but not limited to alignment of interests
  - Risk management practices
  - Human capital practices, including but not limited to fair labor practices, health and safety, responsible contracting and diversity
  - Environmental practices, including but not limited to climate change and natural resource availability regards to long-horizon investing.

"A long time investment horizon is a responsibility and an advantage."

"Long-term value creation requires effective management of three forms of capital: financial, physical and human."

Proposed long-horizon investing beliefs

Based on working group discussions we propose **nine core investment beliefs for long-horizon investment** for investors to consider and adapt. They are not claimed to cover all aspects of long-horizon investing. They reflect our working group's collective understanding of the key success factors for long-horizon investment.

They are deliberately high-level and succinct, similar to the core beliefs held by CalPERS. We hope they are reflective of good insight (smart) although without individual contexts they cannot, by definition, be edgy (reflective of competitive positioning).

These core beliefs are followed by detailed narratives to justify why we hold them. It is our hope that by following through our thought process, investors can apply individual context and judgement to develop their own set of long-horizon investing beliefs that give them an edge over others.

We start by addressing some foundational questions (the "why"): what is the key advantage of having a long time horizon? What are the benefits of engaging in long-horizon investing, from both a micro/individual investor's perspective and a macro/societal point of view? Given its inherent long-term nature, we cannot ignore sustainability and ESG.

Then we move on to beliefs with regards to addressing implementation (the "how"): governance, alignment and measurement.

While complete adoption of all these beliefs by an investment committee may not be necessary, in our view disagreement about a majority of them may signal that an investment entity is not suited to a long-horizon investment program.

1

The competitive edge for long-horizon investors is determined by their ability (skillsets) to identify long-term opportunities and their willingness (mindset) to maintain their position in the face of short-term performance issues.

"(A) long-term investor is someone who is never obliged to sell assets because of prevailing market conditions."
*– **David Denison** (2010)*

*"Long-term investing can be usefully defined as investing with the expectation of holding an asset for an indefinite period of time by an investor with the capability to do so." – **World Economic Forum** (2011)*

*"A long-term investor is one who can hold any investment strategy for as long as the investor wishes." – **Adrian Orr** (2015)*

"Long-term investors are best characterized by their latitude and intent to pursue long-term goals... long-term investors must have a capacity for patience. In turn, that is intimately related to possessing discretion over trading. Long-term investors...must have the intent to invest for the long term. In this regard, long-term investors are characterized by their investment approach."
*– **Geoff Warren** (2016)*

While a consensus definition does not seem to exist for long-horizon investing, the key message of the selected quotes is in fact rather similar, recognising that those investors that are able to take a long-term view have a competitive edge over others that are not.

It starts with a belief that financial markets are not completely efficient[1]. In the short term, swings in investment sentiment can create large divergences between prices and fundamental values. In the long run, however, financial markets may act as a "weighing machine[2]" i.e. prices and values are likely to converge eventually.

The timing of the price-value convergence is extremely difficult to predict, if possible at all. Prices can over- or undershoot values for a sustained period of time, leaving short-term investors at the mercy of markets to move quickly enough to reflect their views. As Keynes rightly pointed out – "the market can stay irrational longer than you can stay solvent" – this activity can be very challenging, if not dangerous.

As a result, the key competitive edge of long-horizon investors is their ability (skillsets) to identify the price-value divergence opportunity and willingness (mindset) to patiently wait for the convergence to eventually take place, regardless of the required holding period (assuming the investment thesis remains intact).

In other words, long-horizon investors can participate in opportunities with uncertain timing regarding their future positive payoff as long as they have high conviction on the investment proposition itself.

The drivers of long-horizon investment outcomes are very different from the drivers of short-horizon investment outcomes. It is common to hear that one of the important roles of active management is to assist with "price discovery". We have already argued that in the short term price can stray far from value, and so it is reasonable to infer that price discovery requires an understanding of order flow and of the expectations of other traders.

In contrast, in the **Kay Review**, John Kay put forward the idea of "value discovery". In the context of equity investment this amounts to attempting to establish the nature and sustainability of the long-term competitive advantage of the business, which in turn will affect its potential long-term earnings and cash flow. It is our view that long-horizon investing is compatible with value discovery.

GIC[3], the Singaporean sovereign wealth fund, make a disciplined approach to long-term value investing the heart of their investment philosophy. They seek opportunities where there is a clear difference between the current price and the intrinsic value of an asset. They believe a long-term orientation is key to successfully executing this approach.

2

Long-horizon investing does not oblige investors to hold for long periods as new investment conditions and prices will support changes to long-horizon portfolios.

Long-horizon investing, for us, is an ex-ante concept that has its key emphasis on the mindset and skillsets. It is not necessarily a function of time although it can take time for price and value to converge. Long-horizon investing is by no means a rigid buy-and-hold approach. The ex-post holding period is driven by the speed at which price and value converge instead of a pre-determined long duration.

A long-term approach is compatible with an element of dynamism when conditions and circumstances fundamentally change over time.

3

Long-horizon investing allows investors to enhance returns by accessing investment opportunities that are not available to short-horizon investors and by avoiding certain drags on investment returns that short-horizon investors incur.

In a previous publication[4], we have documented extensive evidence to suggest that there is potentially a net premium of up to 1.5% pa available to long-horizon investors.

The competitive edge we discussed at length gives rise to a number of investment opportunities that are not obviously available to short-horizon investors.

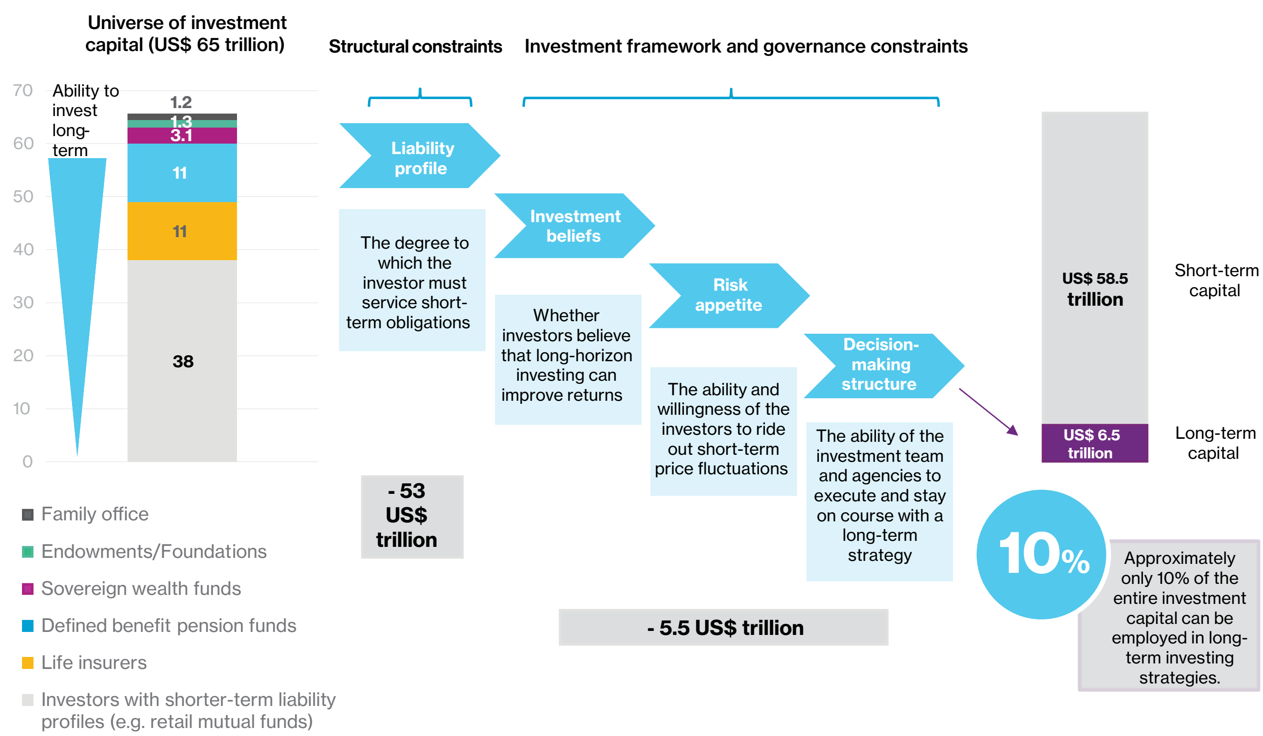
[1] Stronger Investment Theory, Thinking Ahead Institute, 2016
[2] "In the short run, the market is a voting machine but in the long run, it is a weighing machine." – Benjamin Graham
[3] "GIC's Long-Term View", Lim Chow Kiat, Perspectives on the long term, FCLT, 2016
[4] "The search for a long-term premium", Thinking Ahead Institute, 2017

For example, with a long time horizon, investors can tie up their capital in certain illiquid assets and demand a premium for doing so. It is possible for long-horizon investors to forecast (and position for) some structural changes which often take years, if not decades, to fully occur, and therefore create value through investing thematically.

A long-horizon mindset ("be fearful when others are greedy, and greedy when others are fearful[5]") suggests that there is an option value for investors to hold some cash in reserve to purchase under-priced assets, particularly during liquidity crises when there are many forced sellers.

While there is no guarantee that price and value won't continue to diverge for a sustained period of time (particularly when markets are in panic mode), long-horizon investors are expected to be able to ride through short-term mark-to-market underperformance and patiently wait for the price and value to start converging.

Figure 3: Future of Long-term Investing, 2011, World Economic Forum



With the focus on "value discovery", a long-horizon investing mindset can usefully guide behaviours to avoid certain drags on investment returns. An obvious benefit would be lower transaction cost due to less frequent short-term trading.

Considerable evidence[6] suggests that investors, both individual and institutional, engage in buying high and selling low and as a result they give up substantial returns. This past-performance-chasing behaviour is effectively a "price discovery" activity that is fundamentally incompatible with a long-horizon mindset. Forced selling is another source of return drag and, by definition, long-horizon investors should never be forced to sell.

While a net positive long-term premium exists in theory, practically harvesting this premium poses enormous implementation challenges. However, it is reasonable to assume the long-horizon premium exists precisely because it is so hard to capture. In fact, 80 years ago, Keynes wrote a whole chapter on how hard long-term investing was and clearly nothing much has changed since then.

The 1997 "The limits of arbitrage" paper written by Shleifer and Vishy made a similar argument to support the persistence of a long-term premium. They argued that trading on long-term mispricing is generally more expensive and difficult (e.g. the asset manager may be fired before an ultimately-successful long-term strategy pays off). This barrier to entry makes trading on long-term mispricing particularly rewarding for those who can successfully overcome the skill and implementation hurdles.

From the perspective of the supply of long-term capital, most investors face considerable constraints that prevent them from being truly long-term focused in their entire portfolios. The nature of liabilities and liquidity requirements are significant obstacles, along with investment beliefs, risk appetite and decision-making structures.

A World Economic Forum (WEF) study (see figure 3) concluded that only 10% of the entire institutional investment capital can be employed in long-term investing strategies. Additionally, the WEF predicted a further decline in long-term investment capital at the aggregate level. While we believe that this study might underestimate the total supply of institutional long-term capital, given the constraints faced by investors, in our opinion the long-term premium is far from being arbitraged away.

4 Long-horizon investing creates greater societal value through a more effective, efficient and sustainable wealth creation process.

The societal purpose of long-horizon investing is turning savings into wealth. It involves pooling the savings of end savers and deploying them into enterprises that generate good returns and create wealth sustainably over the time horizons that match the real needs of those end savers.

It is our view that an important distinction needs to be made between long-horizon investing activities that exploit mistakes by other investors (and therefore are a zero-sum game from a societal point of view) and activities that improve the overall return of the market (the "beta"). It is the latter for which we believe collaboration, the foundation of our Institute, is most fruitful. It is perfectly aligned with our fundamental mission: to change the investment industry for the benefit of end savers.

These activities include improving investee company operating efficiency by being active and engaged owners (more on this in the next belief). Research suggests firms with a higher proportion of engaged long-horizon shareholders make better corporate decisions, leading to higher profitability and reduced risk in the long run[7].

We believe ownership engagement is currently still very much a box ticking exercise by most parts of the investment chain, calling for a redefinition of the asset manager role to encourage active ownership. Collaborative engagement efforts are important to give the asset management industry a stronger voice.

Society can also benefit from long-horizon investors financing long-term productive activities and being a stabilising force in financial markets at times of market stress[8].

[5] Warren Buffett
[6] See "The Selection and Termination of Investment Management Firms by Plan Sponsors", Goyal and Wahal, Journal of Finance, 2008, and Timing Poorly: A Guide to Generating Poor Returns While Investing in Successful Strategies", Hsu et al, Journal of Portfolio Management, 2016
[7] "Do Long-Term Investors Improve Corporate Decision Making?", Harford et al, January 2017
[8] "Long-term investing: An institutional investor perspective", Geoff Warren, 2014, CIFR

5

Long-horizon investors have the ability to develop long-term relationships with investee companies and to be active and engaged owners, through both active and index tracking holdings.

As previously mentioned, CalPERS view a long horizon both as an advantage and a responsibility. CalPERS actively engage with investee companies and external managers on their governance and sustainability issues, leading to fruitful outcomes. A study[9] evaluated the performance of the stocks of the 183 companies targeted by CalPERS from its engagement process from 1999 through 2012. It suggested that over the five years after CalPERS' engagements, targeted companies on average produced excess return of 12% above the Russell 1000 Index compared to 39% underperformance for the same stocks over the three years prior to the initial engagements.

Another study[10] examined more than 2000 highly-intensive engagements focusing on ESG issues with 613 US public firms between 1999 and 2009. Engagements with investee companies on average generated positive abnormal returns of 2.3% over the year following the initial engagement.

Engagements on corporate governance and climate change issues were found to produce the highest returns. What's more, after successful engagements, investee companies continued to improve their operating performance and governance.

We believe ownership engagement is currently still very much a box ticking exercise by most parts of the investment chain, calling for a redefinition of the asset manager role to encourage active ownership. Collaborative engagement efforts are important to give the asset management industry a stronger voice.

[9] "Update to The "CalPERS Effect" on Targeted Company Share Prices", Junkin, 2013, Wilshire Associate

[10] "Active Ownership", Dimson et al, Review of Financial Studies, 2015

6

Systematically considering sustainability issues, including but not limited to ESG, will lead to more complete analyses and better-informed investment decisions.

Deutsche Bank Climate Change Advisors[11] conducted a meta-study of more than 100 academic studies on sustainable investing. They concluded that there is strong evidence to support the view that sustainable investing and ESG analysis are beneficial to both investors and investee companies.

For example, 89% of the studies they examined show that companies with high ratings for ESG factors exhibit market-based outperformance. They suggested that ESG analysis should be built into the investment processes of every long-horizon investor, and into the corporate strategy of every company that cares about shareholder value.

A more recent Willis Towers Watson[12] paper, which collected evidence from nine studies/meta-studies, showed reduced cost of equity, better stock performance and lower fixed-income spreads as examples of how appropriate management of ESG factors can lead to improved risk and return outcomes.

Sustainable investing, in our view, encompasses the consideration of long-term opportunities and risks, including, but not limited to, ESG factors. We believe that long-term sustainability issues have a material impact on risk and outcomes, both financial and non-financial. These risks are typically under-appreciated by the market, so investors should look to improve long-term outcomes through stewardship and avoiding unrewarded risks

[11] "Sustainable Investing: establishing long-term value and performance", DBCCA, 2012

[12] "Sustainable investment: show me the evidence", Willis Towers Watson, 2017

7 Addressing the governance challenge of long-horizon investing requires a major shift of mindset and significantly expanded skillsets.

"Investment based on genuine long-term expectation is so difficult to-day as to be scarcely practicable. He who attempts it must surely lead more laborious days and run greater risks than he who tries to guess better than the crowd how the crowd will behave; and, given equal intelligence, he may make more disastrous mistakes. ... It needs more intelligence to defeat the forces of time and our ignorance of the future than to beat the gun. Moreover, life is not long enough; human nature desires quick results, there is a particular zest in making money quickly, and remoter gains are discounted by the average man at a very high rate. ... Furthermore, an investor who proposes to ignore near-term market fluctuations needs greater resources for safety and must not operate ... with borrowed money ... Finally it is the long-term investor, he who most promotes the public interest, who will in practice come in for most criticism."

– ***"The General Theory of Employment, Interest and Money"JM Keynes*** (1936)

At its core, long-horizon investing is a governance challenge. Issues that manifest over long time frames can be very difficult for fiduciaries/governance bodies to measure and manage. "Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally"[13] – the willingness and ability to stay the course particularly through periods of poor returns (for the fundamentals to eventually play out) is a key governance challenge.

Addressing that challenge starts with clearly articulated, documented and socialised long-horizon investment beliefs and with objectives that are consistent with the mission and liabilities. It requires buy-in to a long-term ethos from organisation, board and sponsor. Well-framed, documented and skill-based long-term decision processes need to be in place and resources are required to undertake complex qualitative monitoring.

It is our belief that long-horizon risk management is fundamentally different. It requires making mission impairment central and weathering short-term volatility[14]. Long-horizon risk management also requires considering time diversification as well as cross-sectional diversification and giving more emphasis to money-weighted results.

Even with a long-term approach, an element of dynamism can be important as conditions and circumstances fundamentally change over time. Long-term risk/return premia and investor risk tolerances vary through time, so real-time portfolio changes can be important. This involves responding to new prices and investment conditions with changes to portfolios that retain the essential long horizon framework but trade positions where price-value convergence has occurred to new situations where it is yet to occur. The greater the level of dynamism, the greater the governance required.

When thinking of skillsets and mindset, the value of diverse perspective is evident. In a team setting the goal is attaining cognitive diversity through team composition and process. Under most circumstances cognitive diversity will help improve investment decision-making, leading to better outcomes for investors[15]. Decision making groups with diverse thinking styles are found to be less vulnerable to overconfidence, which manifests mainly through over-trading and overweighting risky positions – neither of which is compatible with long-horizon investing.

[13] JM Keynes (again)

[14] "The wrong type of snow", Willis Towers Watson, 2012

[15] "A cognitive take on diversity", Thinking Ahead Institute, 2017

Cognitive diversity can also lead to information-processing advantages, greater cognitive resources (skills, perspectives, knowledge, and information) and capacity for non-consensus views. These ought to prove extremely valuable for enhancing the ability to stay on course during underperformance.

8 Long-horizon investing intensifies the difficulty of aligning agents (both internal and external) across the entire investment chain.

The investment chain represents the set of intermediaries that links savings and investments to the engines of economic growth and development. Over the years the investment chain has expanded to involve more, increasingly specialised intermediaries.

The chain directly connects asset owners, asset managers and investee companies, with more indirect connections to other intermediaries including investment consultants. Misconnection, misalignment and agency issues can all get in the way of value creation.

David Neal, CEO of Future Fund, co-authored a paper with Dr Geoff Warren in 2015 addressing long-term investing as an agency problem. "To make things worse, the long term is not going to arrive anytime soon. There is no immediate feedback loop... It is this temporal gap between the decision and the (uncertain) payoff that exacerbates the agency issues associated with investing for the long run – especially when things don't initially turn out as expected."

[16] "To bonus or not to bonus", Tim Hodgson, 2017

[17] "Drive: the surprising truth about what motivates us", Dan Pink, 2009

[18] "The Long-Term Portfolio Guide", FCLT, 2015

[19] "Portfolio Construction and Performance Evaluation for Long-term Investors", Geoff Warren, CIFR paper 2015

The problems that are particularly relevant for long-horizon investing, the paper suggested, include how principals monitor agents; the tendency to reward for short-term mark-to-market performance; how to deal with short-term underperformance; and the agency risk associated with commitment.

Organisational settings can be better aligned with clear objectives and guiding principles. Long-horizon investors should aim to achieve alignment via nurturing a long-term culture. The idea is to build long-horizon investing into the organisational 'DNA'.

We believe that long-term partnering relationships between asset owners and asset managers support higher and more sustainable investment returns. Maintaining long-term relationships between owners and managers is based on trust and needs an ongoing exchange of value and investment of time. Cultural compatibility is a critical factor in supporting long-term relationships between asset owners and asset managers.

A fit-for-purpose design of fees and incentives is at the centre of addressing misalignment. Variable pay[16], in the form of bonus or performance fee, does not necessarily always create appropriate alignment despite its wide adoption across the industry. Intrinsic incentives that derive from leadership and management promoting high levels of professionalism and build an emphasis on the tendency to "do the right thing"[17] can be far more important and powerful in driving behaviours and creating alignment. Long-termism should be emphasised in career development for all internal staff.

9

The quantitative measurement and qualitative assessment of internal and external asset managers should emphasise process, behaviours and consistency with long-term focus.

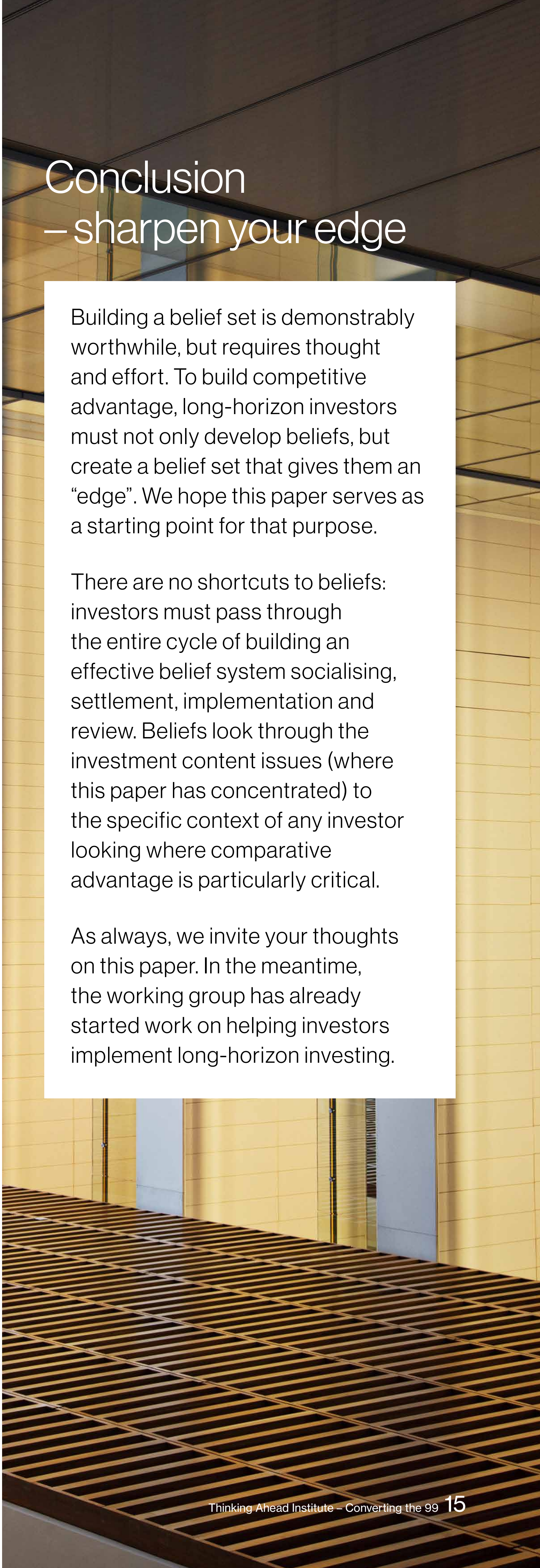
What gets measured gets managed. Evaluation over shorter periods should concentrate on whether investment strategy is in line with stated investment beliefs and thesis while recognising the magnitude of noise/luck that is present in short-term performance.

Benchmarks exert outsized influence on investing decisions. As a result, long-term thinking can be compromised by ill-suited benchmarks. Benchmark design for long-horizon investing should focus on assessing value creation over the long term and ensure consistency with liabilities/obligations/mission.

It is important to address the potential conflict between an absolute return target required by long-horizon investors (e.g. CPI +x% pa) and objectivity for the asset manager (e.g. return relative to opportunity set).

Focusing Capital on the Long Term (FCLT)[18] advocated employing benchmarks at two distinct levels: the strategy level (e.g. a multi-year absolute return target) that reflects the asset owner's intended investment strategy and is used to assess the success of the strategy itself; and the execution level (e.g. fit-for-purpose equity indices) that is used to assess asset manager's execution taking into account the opportunity set.

Performance evaluation for long-horizon investors should ideally focus attention on the key driver of long-term returns – cash flows generated over the long run – while deemphasising price fluctuations arising from other sources. Geoff Warren[19] developed an integrated approach to long-term performance evaluation in order to address the need of this focus.



Conclusion – sharpen your edge

Building a belief set is demonstrably worthwhile, but requires thought and effort. To build competitive advantage, long-horizon investors must not only develop beliefs, but create a belief set that gives them an "edge". We hope this paper serves as a starting point for that purpose.

There are no shortcuts to beliefs: investors must pass through the entire cycle of building an effective belief system socialising, settlement, implementation and review. Beliefs look through the investment content issues (where this paper has concentrated) to the specific context of any investor looking where comparative advantage is particularly critical.

As always, we invite your thoughts on this paper. In the meantime, the working group has already started work on helping investors implement long-horizon investing.

Limitations of reliance

Limitations of reliance – Thinking Ahead Group 2.0

This document has been written by members of the Thinking Ahead Group 2.0. Their role is to identify and develop new investment thinking and opportunities not naturally covered under mainstream research. They seek to encourage new ways of seeing the investment environment in ways that add value to our clients.

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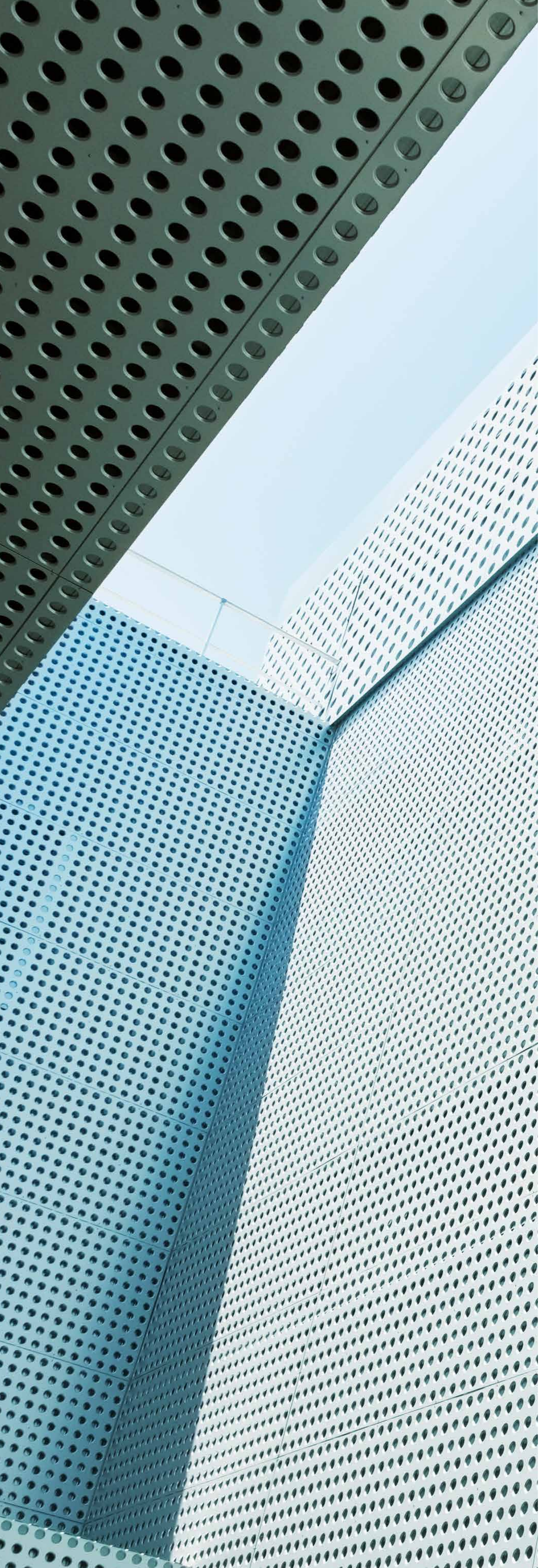

About the Thinking Ahead Institute

The Thinking Ahead Institute seeks collaboration and change in the investment industry for the benefit of savers.

It was established by Tim Hodgson and Roger Urwin, who have dedicated large parts of their careers to advocating and implementing positive investment industry change. Hodgson and Urwin co-founded the Thinking Ahead Group, an independent research team in Willis Towers Watson, which was created 15 years ago to challenge the status quo in investment and identify solutions to tomorrow's problems.

What does the Thinking Ahead Institute stand for?

- Belief in the value and power of thought leadership to create positive investment industry change
- Finding and connecting people from all corners of the investment industry and harnessing their ideas
- Using those ideas for the benefit of the end investor.

The membership comprises asset owners and asset managers and we are open to including membership of service providers from other parts of the industry. The Thinking Ahead Institute provides four main areas for collaboration and idea generation:

- Belief in the value and power of thought leadership to create positive investment industry change
- Working groups, drawn from the membership, and focused on priorities areas of the research agenda
- Global roundtable meetings
- One-to-one meetings with senior members of the Institute.

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