Thinking Ahead Institute

Patience: not merely a virtue, but an asset

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A critical link

This paper considers the link between 'patience' and investing successfully for the long term. It is based on two interrelated ideas. First, patience differentiates between long-horizon and short-horizon investors. Second, patience must be seen as a depreciating asset. Left unmanaged, patience will erode and lose its value.

The thesis we explore has two components:

1. Patience has value, because it: (a) supports the ability to invest for the long term, and (b) allows the maintenance of (initially) losing positions.
2. Patience running out is bad, because it: (a) can trigger a value-destructive sale (capitulation), and (b) sends the wrong signals, which can undermine capacity to exercise patience in future.

We consider an investment that has a high chance of delivering a very handsome return. The only problem is that we don't know when. The return could materialise tomorrow, or years down the track. What type of investor would pursue such an investment? Clearly, they must have patience. They must not be too concerned with when the payoff might arrive, although they should worry if it will eventually occur. They must be able to stay the course if the payoff is delayed. Being able to pursue such investments opens a class of potentially rewarding opportunities that impatient investors may overlook.

Our thesis suggests a straightforward question – how does an organisation build and sustain patience?

The question becomes somewhat more complex when there are multiple levels of two-way relationships, and there is the need for patience to span those levels. Nevertheless we suggest that a simple, generalised model with four elements can be used to explore the question:

1. Two-levels – such as principal-agent, or governor-executive – but more generally a high-level party and a low-level party. We exclude the single-level case of the principal investing on their own behalf. The two-level idea applies variously: within asset owners (board and in-house executive); between asset owners and asset managers; and/or within asset managers (boss-employee).
2. The stock of patience resides with, and is controlled by, the high-level party (eg principal).
3. The low-level party (eg agent) operates under a mandate while the stock of patience remains positive. The manner in which this is done influences the principal's stock of patience.
4. There may, or may not, be a shared understanding of the presence of patience, let alone agreement over the role it plays. However, we assert that the best relationships and investment outcomes will involve mutual agreement over the need for patience.

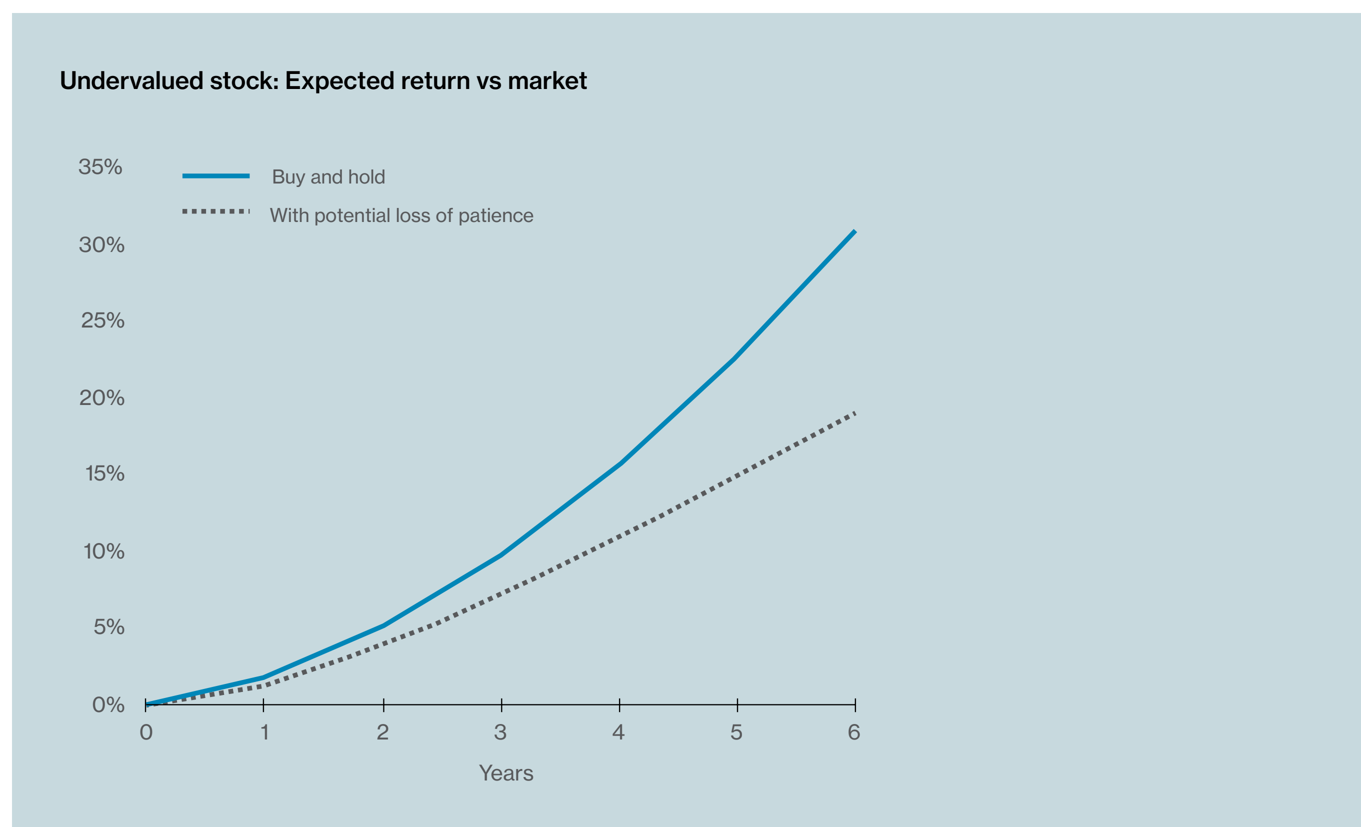
In this paper, we develop the stance that patience can be viewed as an asset. We describe the benefits of possessing a stock of patience, and hence being able to pursue long-horizon investments where payoff timing is uncertain; and what happens when patience wears thin. Both organisations and people may differ in their stock of patience. This stock can be sustained or even enhanced if managed and nurtured; but will depreciate if untended, and can erode rapidly if abused. We provide some suggestions of what to do, and what not to do, in building and maintaining a stock of patience.

When patience is required: an example

To illustrate why patience is valuable, we construct a simple yet revealing example. Assume an investment has the potential to outperform by 50% in due course. However, a catalyst is needed. The investment might be a deeply undervalued stock that requires either a sign that the fundamentals are turning, or perhaps a takeover bid, before the market will recognise the value. Or it could be a mis-managed company, and existing management must be dislodged before the value can be realised. Whatever the case, there is potential to capture value, but the timing is unclear. We portray the situation using the following assumptions:

- The stock's relative return index will jump to 1.5 if a catalyst arrives, ie 50% outperformance.
- A 12.5% probability in year 1 through year 6 that the catalyst occurs, summing to a 75% probability.
- The remaining 25% probability is that it never happens, and the stock turns out to be a value trap.
- Underperformance of 5% pa until the catalyst arrives; cumulative loss is -26% if this never happens.
- As well as a baseline 'buy and hold' investor, we extend the calculations for an investor 'at risk of losing patience'. We do so by allowing for a (conditional) 12.5% pa probability of selling out if the catalyst does not arrive, with the sale at 5% below the prevailing price due to being a desperate seller.

The chart below plots the expected relative return as a function of the investment horizon. A very attractive expected return is on offer for the buy and hold investor, which builds with horizon to 31% by year 6 – notwithstanding the 25% probability it could be a value trap. The gain/loss ratio in year 6 (based on multiplying gains and losses by their probabilities) is about 5.7 times. Altogether not too shabby. However, closer consideration reveals that the stock may not be too attractive to an investor who lacks patience, for three reasons.



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First, at the end of year 1, the expected return is only modest at about 2%; and is coupled with an 87.5% probability that the investment will underperform (by 5%). Even by the end of year 3, when the expected outperformance is about 10%, the chance of having underperformed (for three years in a row) remains at 62.5%. The investor needs to anticipate being able to stay the distance (six years) before it starts to look like a potential 50% upside with a 75% chance. How many investors would rather overlook such an opportunity, and search for another investment that offers a higher chance of delivering over a shorter time frame? Many would not have the patience.

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Second, the attraction of the investment is attenuated substantially by the risk of losing patience, and hence being forced to sell out early. The expected return with potential loss of patience tracks at a much lower level, dropping from 31% to about 19% over the full six years. One reason is that failure to stay the course means missing out on the possibility of capturing any value that might be ultimately realised. Another is we assume that the investor incurs a 5% cost for being a desperate seller. These aspects are meant to reflect occasionally-seen situations where an investor, their boss, or those providing the funding lose faith and decide to head for the exits. The chart below drives home the consequences of potential loss of patience, by plotting the cumulative probabilities attached to the possible outcomes. Once the risk of losing patience is built in, the probability of ultimately capturing the value drops from 75% to about 55% under our assumptions, ie it moves closer to a 50/50 bet.

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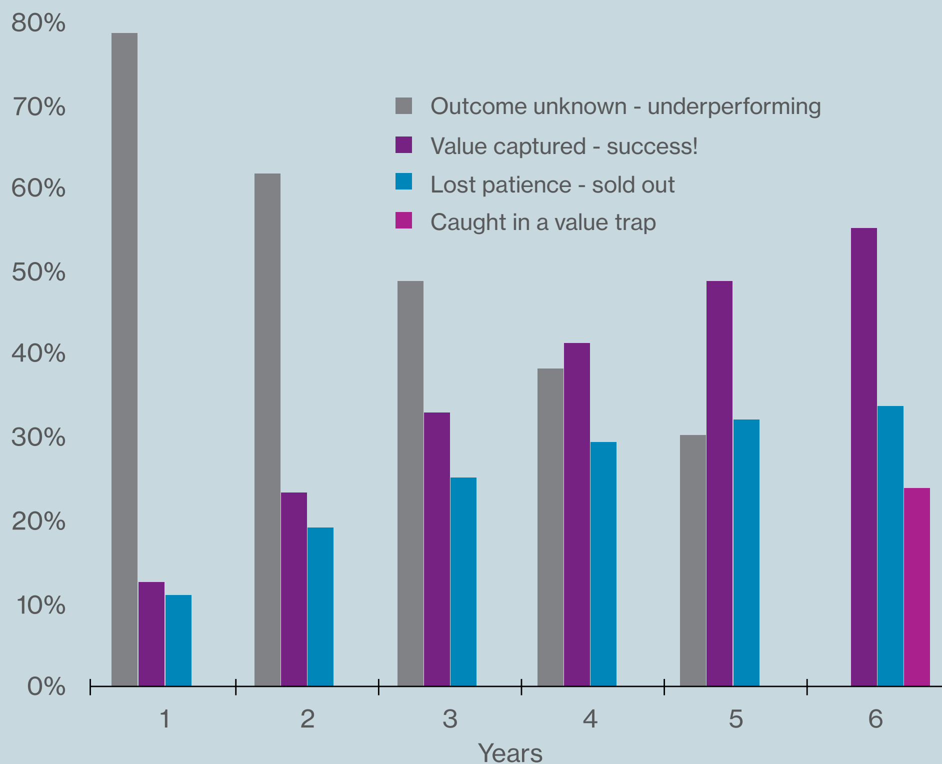
Third, the example illustrates what happens when the resolution of uncertainty may take time (in this case, up to six years). The investor faces the prospect of residing in a state of uncertainty for an extended period, wondering not only when, but also if, the value might be realised. In other words, patience is probably going to be tested. This is only going to make it all the more difficult to stay the course.

Undervalued stock: Cumulative probability of outcomes



This is, of course, just an example that is highly dependent on the assumptions. But it is instructive nevertheless. It hints that patience is an asset that may pay dividends by allowing an investor to access certain types of investments, notably those where the payoff is potentially attractive but the timing is uncertain. It also highlights how a loss of patience may be costly, and that patience is likely to be tested. In summary, it is important to maintain the stock of patience if one is going to try to take the long road and stay the course. Finally, the example is designed to illustrate the role of patience, and not meant to imply that long-horizon investing equates to a six-year time frame!

We now turn to discussing the type of strategies where patience may be particularly valuable, before moving on to a discussion of what can be done to build and sustain the stock of patience.

Patience can pay high dividends

The above example highlights the advantage patient investors have over others. Specifically, they possess an ability to access additional opportunities, in particular those that are likely to produce a positive payoff, but with uncertain timing.

It is important to note that patience alone does not lead to investment success. Patience is no substitute for skilled investment analysis. The example implicitly assumed a highly-skilled investment process that identified a high likelihood (75%) of an attractive payoff (50% outperformance). The attractiveness of the investment would fall quickly if the possibility of a value trap increased, even to investors with a long time horizon.

Assuming genuine investment skills are given, what difference would patience make?

An investor has, broadly, three options for allocating their capital:

1. *Risk-free assets* – These give a 100% likelihood of a (very) low return.
2. *Price-to-price investing* – This is Keynes's beauty contest game. It entails predicting the movement of psychology of the market. What matters is the price bought at, and the price sold at.
3. *Price-to-value convergence* – Here there is a high likelihood of an attractive payoff, and skill relates to accurate assessment of the value. But there is also the possibility that price and value remain divergent. The divergence might even get larger before convergence occurs.

Clearly for the first option, patience makes no difference. The second option is a noisy, zero-sum game and so doesn't seem a natural place for patience to make any difference. For price-to-value convergence, however, we argue that patience is everything.

In our above example, the price is $1.00, the potential value is $1.50, and the expected value allowing for the possibility of a value trap is $1.31. Further, we assumed that the price would underperform by 5% each year until the catalyst triggers the re-pricing. This was a deliberate choice to introduce price divergence, while waiting and hoping for convergence. The risk of further divergence is a real risk faced by most investors, and an aspect that will really test patience.

If price diverges from value the investor has three options: (a) sell, concluding that their analysis of value was wrong, (b) do nothing, or (c) add to the position as the prospective return has increased. The thesis being explored in this paper is that patience is an intangible asset that allows an investor to pursue options (b) or (c).

In the long run, we believe that financial markets act as a "weighing machine" (Benjamin Graham), ie prices and values are likely to converge eventually. However, to predict when prices and values converge ultimately requires understanding market psychology. Under our belief system, this is extremely challenging, if not impossible. Given the skill to identify opportunities from price-to-value divergence, patience bridges the gap between a likely attractive payoff and the uncertain (unknowable?) timing associated with that payoff.

To summarise, divergences between prices and fundamental values can be identified by skilled investors, but are best exploited by investors who are both skilled and patient. This is value investing. In passing, we note that value investing can manifest in many forms, for instance:

- Thematic investing, which involves forecasting and positioning for structural changes which may unfold over years, if not decades.
- Exploiting the option value in cash, by holding some reserves to purchase under-priced assets, particularly during liquidity crises when there are many forced sellers. This flows from the mind-set of *"be fearful when others are greedy, and greedy when others are fearful"* (Warren Buffett).

- Ownership that engages with investee companies, in order to improve the long-horizon value of these companies (partly aimed at influencing value itself).
- Investing in illiquid assets has a value component, to the extent that a higher value can be placed on illiquid assets by patient investors. Illiquid assets can also become 'under-priced' and offer large illiquidity premiums when short-horizon investors are in need of near-horizon liquidity.

Patience not only expands the opportunity set. It can also protect against value-destructive short-horizon behaviours such as 'selling low', as alluded to in our example. Another equally important but more subtle benefit is the ability to stay put – refuse to 'buy high' in an 'over-heated' market. The principal-agent issues arising from delegation in the investment industry make such misbehaviours particularly challenging to address, as they create peer pressure and career risk. Keynes' observation applies here: *"...it is better for reputation to fail conventionally than to succeed unconventionally."*

One more obvious 'dividend' that patience can pay is reduced transaction costs as a consequence of lower portfolio turnover. It is important to caveat this statement, as patience needs to be exercised intelligently. Blindly sticking to an investment case that is no longer valid might appear like patience, but is actually being unskilled. However, it is reasonable to expect long-horizon strategies to have significantly lower turnover compared to short-horizon trading strategies.

Putting all benefits together requires making some heroic assumptions and carefully accounting for how different strategies interact. This is probably why such attempts are rare. A 2017 study by the Thinking Ahead Institute suggests that the aggregate benefit to patience – the long-horizon premium – can be up to 1.5% per year. This is a substantial return-enhancing opportunity for any investor not completely constrained by liability and liquidity needs.

What causes patience to wear thin

While the focus of this paper is patience as an asset, the underlying thesis is that patience is the key differentiating feature between long-horizon investors and short-horizon investors or 'want-to-be' long-horizon investors. An alternative way of expressing this idea is that an investor's true time horizon is tested by, and only revealed by, adverse outcomes. When returns are favourable, the concept of *long-term* carries very little meaning or importance. We can illustrate this by returning to our opening example. Recall that the stock will outperform by 50% if the catalyst occurs. Suppose that the catalyst occurs in year one, or even year two. We then have a very satisfied investor, able to sell the stock at a significant profit. But are we able to tell whether this investor has a long-horizon or not? No!

We can generalise and conclude that, if returns are always favourable, we will be unable to identify any genuinely long-horizon investor. Hence our statement that true time horizon is only revealed by adverse outcomes, because it is only with underperformance that the behaviours of short-horizon and long-horizon investors will differ. Implicit within this is a belief we should call out: long-horizon investors should only expect to earn a return premium if they can survive periods of adversity. It is during such times they need to make disciplined, value-adding decisions – even if those decisions are to *do nothing*.

It follows that patience will be tested. This leads to the idea that patience should be viewed as a depreciating asset. In fact, we can define the observed behaviour of 'capitulation' as the point at which patience ran out. In our example, the investor that capitulates (runs out of patience) and becomes a desperate seller after weak performance is a short-horizon investor. The long-horizon investor has sufficient patience, or manages it more effectively, to ride the underperformance and ultimately capture the payoff[1].

So what causes patience to wear thin? Our argument so far is that adverse performance will appear as the primal cause of a reduction in the stock of patience. However, it is better viewed as the trigger for underlying issues to surface. Hence it is instructive to delve deeper. Beliefs, expectations and uncertainty all play a role. And all are compounded by the agency problem.

- *Beliefs* – Investment decisions are about an uncertain future, and so must be based on investment beliefs. Issues arise when there is a gap between the beliefs of the principal and those of the agent – or between reporting layers within an organisation. A mismatch in beliefs is likely to contribute to the eroding of patience. If the beliefs have not been adequately aired and discussed, then it is possible that an adverse outcome could be consistent with the agent's beliefs but not those of the principal. In this situation the potential for mis-communication – and the threat to patience – is high.
- *Expectations* – This relates more to the anticipated pattern of return outcomes, rather than the belief in the mechanism producing them. But the effect is essentially the same. A mismatch in expectations will erode patience as above, whether of itself, or through mis-communication.
- *Uncertainty* – No matter how well-developed our beliefs, or solidly-founded our expectations, the future remains fundamentally uncertain. We know that we don't know perfectly, and so adverse outcomes will naturally trigger doubt. If doubt is not openly expressed and discussed, it can quietly corrode the stock of patience.

These three elements relate to adverse performance being either misunderstood or misinterpreted. There is a further, somewhat technical, point related to *path dependency*. If you take a series of returns and compound them into an overall return, then you get the same final result no matter in which order you place the individual returns.

[1] Please note we are not claiming that value is always created if only an investor has sufficient patience to survive an indefinite period of underperformance. Circumstances change and investment theses can be undermined, meaning the correct decision may be to sell at a loss. The differentiating point is that this is a reasoned decision given a change in expectations about the ultimate return, and not in reaction to the discomfort of reporting, or defending underperformance when the investment case has not changed.

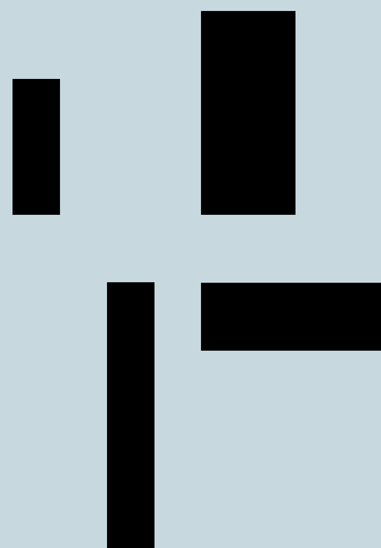
Unfortunately, when it comes to patience and the prospect of capitulation, the order can matter intensely. If an investment gets off to a good start, then a future drawdown imposes less stress on the stock of patience. If the initial results involve drawdown, then the issues raised in the above three points immediately come into play. The likelihood of an investor sticking with an investment therefore depends, to some degree, on the path of the returns.

Beyond the performance data, other elements that can erode the stock of patience include lack of clarity, lack of alignment, and loss of trust:

- *Lack of clarity* – In our generalised model for patience, lack of clarity can engender misunderstanding by one or both of the 'levels' (principal-agent, board-executive, boss-employee) over the mission, objective, or mandate. This confusion is perhaps most dangerous when it is subtle; obvious misunderstandings are likely to be noticed, surfaced, and dealt with.
- *Lack of alignment* – This aspect sits at the root of the principal-agent problem, and simply comes with the territory of principals delegating to agents. The degree of alignment can be influenced or managed. It will be addressed below when we consider the building and maintenance of patience.
- *Loss of trust* – Trust that you are on the right track is central to staying the course, and is especially important when investment management is delegated, ie the high/low level concept within our generalised model. People are willing to cut others a bit of slack if they trust them to do the right thing. If the higher level loses trust that the lower level is diligently working towards agreed long-horizon goals, then doubt will creep in, and patience becomes tested. A quick internet search on 'destroy trust' will return countless pages listing ways to break trust. While not claiming to have discovered the perfect taxonomy, we can group the behaviours into: lying, inconsistency, and other (eg breaking promises, gossip, blame, etc). In the institutional setting, the first two groups are material; while *other* relates more to personal relationships. If *lying* sounds too aggressive in an institutional setting, please feel free to substitute *misrepresentation*.

In sum, when an agent's performance of their duties does not completely match up to the principal's idea of what should be done – whether through a lack of clarity, alignment or poor behaviours – it is likely that patience will come under strain. The principal will start to doubt the agent, and may think about withdrawing their support. Once they get to this point, the stock of patience has run out.

Before switching to building patience, we make one final observation relevant to an institutional setting. We observe from daily life that individuals are not equally endowed with a capacity for patience. Organisations are aggregations of individuals, and the aggregating mechanism is often difficult to understand. While this could stand as a general point about the composition and disposition of boards or teams, we highlight a specific case. The tenure of some long-horizon investments can be a lot longer than the tenure of the individuals involved in the initial decision to invest. Situations may arise where a new CIO experiences underperformance from investments inherited from the previous leadership, or where mandated rotation results in a governing board feeling no ownership of a prior decision. The key is to build a stock of institutional patience that goes above and beyond the current generation of investment decision makers. The aim is to build a long-horizon culture where patience is valued, and long-horizon investing becomes coded into the organisational DNA.



Building the stock of patience

How do we go about building a patient investment organisation, in order to capture the benefits of long-horizon investing? In this section, we address what can be done to create an organisation with a substantial stock of patience from the get-go. Practical suggestions are offered in four areas: gaining organisation-wide buy-in to why and when patience matters; creating a long-horizon oriented investment process; hiring the right people; and building a long-horizon culture. In the next section, we discuss how to maintain the stock of patience on an ongoing basis, ie along the path.

Organisation-wide buy-in

Building patience starts with strong buy-in to the importance of patience across all levels of the investment organisation. That is, the entire organisation needs to be in sync with regard to: (a) a strong belief that patience 'pays a dividend' (if not, why bother building it?), and (b) a clear expectation that patience will be tested.

A strong and robust set of investment beliefs is critical to navigate the long, uncertain and volatile journey of investing. Building strong beliefs requires a structured process, which encouragingly more and more investors have started to embrace in recent years. However, this is not easy:

- The process of developing shared beliefs involves taking something inherently abstract, and codifying it in a clear and more tangible form.
- The process needs to be interactive in order to settle differences of opinion. It is unrealistic to expect a consensus around a useful belief statement.
- The goal is to produce investment beliefs that are smart (reflective of good insight) and edgy (reflective of competitive positioning).
- For investment beliefs to be effective, they need to be validated, documented and widely socialised. They also need to be consistently applied in the decision-making process at all levels.

We have discussed how patience will be tested by periods of adverse performance. If the possibility of adverse performance is expected, it wears out patience at a (much) slower rate. The investment organisation needs to create a shared expectation, right at the beginning, that short-horizon underperformance is simply an inherent by-product of a long-horizon investment programme. This shared expectation can be institutionalised by establishing the expectation of periods of underperformance as a core investment belief that guides decision-making.

Another component of managing expectations is clarity about liabilities and obligations. During the GFC, some endowments and foundations found that they had underestimated short-horizon liabilities, such as calls for committed capital from private equity funds. They had to realise losses to meet these obligations – a so-called capitulation event. It demonstrates the challenges in constructing an accurate expectation of liquidity requirements. Investors should manage their liquidity beyond just analysing short-horizon cash-flow needs. In times of financial market stress, seemingly liquid risky assets can become highly illiquid, forcing investors to sell them at a deep discount.

Seeking commitment from high-level parties is another key component of gaining buy-in to long-horizon investing. In the context of asset owners awarding mandates to asset managers, asset owners need to acknowledge that they are in for the long haul, and should not lightly withdraw their funding or commitment. This will enable asset managers to focus on executing long-horizon strategies and eventually rewarding asset owners for their commitment. A clear understanding of the long-horizon nature of these mandates is likely to help facilitate commitment. While not without their issues, certain lock-in mechanisms are also worth considering to enhance or even secure commitment of funding. Examples include: redemption opt-outs; capacity to defer redemption; and closed-end structures.

Long-horizon-oriented investment process

An investment process uses information as input and produces investment performance as output. The key to building a long-horizon oriented investment process is a clear focus on: (a) information that helps answer the question of ‘if’ there will be a payoff, instead of ‘when’; and (b) working towards long-horizon outcomes. We will address the information set issue immediately below, and circle back to the framing around long-horizon outcomes in the next section.

We discussed earlier how the key competitive edge of patient investors is that they can afford not to worry about when the payoff occurs. To sharpen their edge, such investors should focus on information that supports value discovery, and should look through information designed to attempt to gauge market psychology. For example, in an equities context, instead of focusing on how soon-to-be-released earnings will compare with market expectations, investors should concentrate on the company’s long-horizon cash flow generation potential.

Certain structures and mechanisms can be built into the investment process to alleviate the impact of patience running low. Investment processes that are more rules-driven than discretionary can often engender patience. During times of poor performance, they call for an evaluation of whether the process has been applied correctly or may need rejigging, rather than drawing attention to the issue of ‘who made the mistake, and why?’. It is easier to get through tough times by trusting in a clear and agreed process, than having to address the vagaries of personal views and biases. For example, a rules-based rebalancing approach is a robust way of institutionalising contrarian behaviour; especially if there is no scope for arbitrary deviation from the process during times of stress. With supportive governance, rebalancing rules might include valuation-based metrics to benefit from mean reversion.

People and team

Investment is a people business. The foundation of a long-horizon investment organisation are employees who genuinely believe in long-horizon investing and act accordingly. Below we will talk about how extrinsic monetary incentives can influence behaviour. However, it is our belief that intrinsic characteristics – an individual's innate values, perspectives, knowledge, experiences, and way of thinking – are more powerful for achieving alignment and producing desirable outcomes. The tendency to do the right thing should be a prominent criteria in hiring, including a willingness and ability to challenge the consensus position. Once the right people are hired, commitment to their long-term growth and development should be demonstrated. This should lead to longer tenures, while reinforcing the commitment to long-horizon investing. Basically, you want to employ people who are innately patient and undertake to provide them the support and time to build their careers.

When putting people together in a team, the goal is to build cognitive diversity through team composition and process. Institutional investing is all about group decision-making. We view cognitive diversity as an important concept for building patience, as under most circumstances cognitive diversity will improve investment decision-making. When patience is inevitably tested by adverse performance, a team rich in cognitive diversity supports an environment where non-consensus views are actively solicited and the willingness to go against the crowd is encouraged. It can also lead to information-processing advantages and greater cognitive resources (skills, perspectives, knowledge, and information). All these benefits facilitate a more accurate assessment of *if* there will still be a positive payoff. Where the answer is *still very likely*, then exercising patience and staying on course becomes a straightforward decision. Where the assessment points to a higher chance of a value trap, patience should not be given blindly. Either way, cognitive diversity improves the success rate of long-horizon investment.

However, it is worth noting that diversity is not completed without inclusion and integration. There is a balance between promoting cultural unity versus groupthink. Highly diverse teams with poor integration can indeed lead to more dissenters when times get tough, causing patience to wear thin. Patterns of working within the team should be set early on, and good integration is fostered by introducing appropriate behavioural checklists.

Patient culture as an edge

We previously noted the importance of culture, and simply re-emphasise the point that patience can be built through a deliberately designed culture. The point also segues into the next section of maintaining patience, as culture must be constantly reinforced.

Maintaining the stock of patience

The previous section examined building a stock of patience in the first instance. This section addresses how to maintain it. Any asset tends to depreciate, and thus ongoing investment is required. Patience is no different. The need to replenish the stock is likely to be greatest during times when patience is tested by adverse investment performance. Below we discuss four focus areas for maintaining patience: trust, incentives, framing and leadership.

Trust

We mentioned earlier that behaviours which undermine trust will erode patience. Hence it is important that trust is nurtured along the path. The question is how to do so when investments are delegated by a high-level to a lower-level party. A central strategy is ongoing engagement between the two levels, with the expressed intent of fostering understanding of investment positions and how they relate to the agreed beliefs and expectations. People are naturally more inclined to trust something they understand. The two levels should be engaging over the reasons for investments, perhaps even reaching mutual acceptance if not agreement from the higher level. The loop is then closed by reviewing subsequent performance in terms of how it connects with beliefs and prior expectations. Communication and transparency are key: the aim is to reduce information and understanding asymmetries.

Understanding becomes most important when patience is being tested by poor performance. If the higher level is only aware that performance has been poor without any sense for why, then doubt will arise over whether the investment was wise in the first place, and patience will wear thin. However, if the higher level understands and accepts the reasons for the investment, they are more likely to be receptive to the idea that the lower level should be afforded more time to allow the position to come to fruition. And if it happens that the investment was originally well-founded but the fundamentals have changed, the higher level will be more inclined to retain trust in the lower level and afford them further opportunity.

Consistency is also important. It is harder to maintain trust in somebody when you don't know what they might do next. In investment markets this concept comes under the guise of remaining *true to label*, such as fund managers continuing to invest in accordance with their professed style and process. The sacking of managers for not remaining *true to label* can be viewed through the prism of loss of trust. Lower-level parties can help preserve the stock of patience afforded them by being consistent and predictable in their actions, and by avoiding behaving in ways that are unexpected and inexplicable.

Incentives

Incentives also relate to principal-agent relations, and the lead needs to be taken by the higher-level party. Simply, an agent operating at the lower level is more likely to exercise patience if they expect to be rewarded for it. The problem across much of the investment industry is that lower level parties such as internal executives and fund managers are often evaluated and rewarded for shorter-horizon performance. The rewards extend beyond just bonuses being linked to short-horizon relative returns. They include the manner in which fund flows respond to performance. They also extend to the relation between a recent performance record and aspects like personal career prospects and status within the organisation or industry. The siren calls of the potential rewards for outperforming over the short term act to depreciate the stock of patience ... especially when weighed against the remuneration and career risk implications of waiting for payoffs that are not guaranteed to arrive anytime soon.

At the core of problem is the signals that the higher level can send through what they respond to, and what they reward. Many higher-level parties are supposedly working toward long-horizon objectives, and/or pay lip service to the need for a long-horizon approach. However, they often react to short-horizon performance nevertheless. This sends the message that they do not possess sufficient patience: entirely the wrong signal for encouraging long-horizon investing. Higher-level parties need to remain cognisant that their actions have consequences. They should aim to send strong signals that it is progress towards long-horizon objectives that will be noticed and rewarded. This will encourage patient behaviour from the lower level acting as their agents.

Adjusting incentive remuneration structures has a role to play. Ideas that accord with rewarding progress toward long-horizon outcomes include long-horizon conditional vesting, and incorporating a subjective component within bonus determination. The latter can be used to explicitly encourage and reward long-horizon behaviours. Both of these ideas tweak the industry practice of awarding yearly bonuses, while aligning those bonuses with the patient pursuit of long-horizon objectives.

Further, higher-level parties should be careful not to be seen responding to short-horizon performance, and try to ensure that their actions are interpreted as occurring for other reasons. Asset owners should refrain from chasing performance and churning their managers. Manager reviews should not be triggered by underperformance, but rather only by signs that a manager has been acting in a manner inconsistent with the diligent and patient pursuit of long-horizon objectives. When deciding which staff to promote, performance should be down-weighted in favour of contribution towards the pursuit of long-horizon goals.

Framing

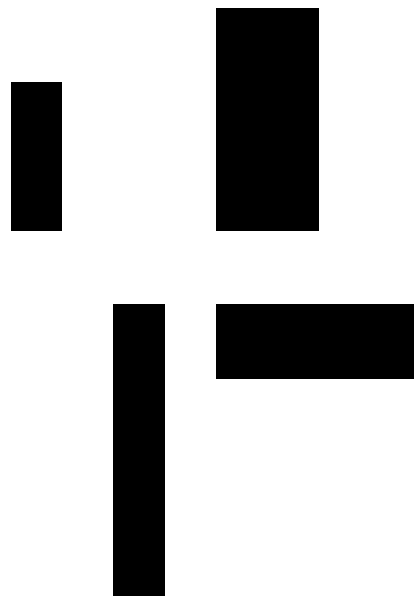
Patience can be affected by the framing of communications, especially around performance. The trick is to focus on the destination, and not be distracted by the journey. Patience can be fostered by making the prospect of long-horizon rewards more salient than short-horizon performance fluctuations. Experimental research suggests that framing is important for limiting myopic loss aversion, which is a behavioural effect under which short-horizon losses are over-weighted and long-horizon outcomes are under-weighted. Strategies found to be effective in reducing myopic loss aversion include focusing on whether outcomes are on track to achieve long-horizon objectives instead of period-by-period results, and establishing less frequent feedback and/or fewer opportunities to take action. These findings give clues on how communications around investment performance might be framed to encourage patience. The appropriate format will depend on the circumstances, but ideas include:

- Place long-horizon rolling performance in a more prominent position in tables that report performance, while performance over the last period is presented as a 'by-the-way ...' manner.
- Plot the long-horizon path of wealth versus target, with the target trajectory extended into the future.
- Report in units that relate to the long-horizon objective. A good example is pension funds reporting estimates of expected income in retirement as the primary basis of member communications, while recent performance is treated as something of a footnote.
- Attribute returns into changes in long-horizon cash flows and changes in discount rates (ie repricing effects), focusing on cash flow revisions as the primary indicator of whether the fundamentals remain intact and hence whether the investment remains on track.
- Direct commentary towards whether the fund is on track to achieve its long-horizon goals, along with discussion of developments affecting long-horizon value drivers, thus eschewing the usual focus on which assets or stocks contributed to returns over the latest period.
- Reporting should be no more frequent than required, and made more meaningful when it occurs. In some situations, a yearly reporting cycle may even be enough. Chuck out the daily or weekly attribution analysis.

Leadership

Finally, those in a leadership position should embrace managing the stock of patience as an important part of their role. Leaders can influence the evolution of culture and tone within their organisation through the examples they set, what they choose to focus on, and what they are willing to tolerate. Some actions that leaders might take to maintain and build the stock of patience include:

- Focus on what needs to be done to achieve long-horizon objectives looking forward, rather than the latest performance numbers. For example, when performance is poor, don't issue a 'please explain'. Rather, ask if anything has changed that is relevant for achieving the long-horizon objectives.
- Constantly reinforce the mission and culture in a way that engenders patience. Send the message that the rewards will come if we stay focused on the long-horizon and continue doing the right thing.
- Ensure responses are measured, and take care with language. No knee-jerk reactions. The word *performance* might be used sparingly and wisely.
- Acknowledge and reward those who exercise patience.
- Show zero tolerance for actions that place short-horizon performance first, or undermine trust.



Concluding thoughts

We have argued that patience is a valuable asset that allows the benefits of long-horizon investing to be accessed. Some of the best investment opportunities involve price-to-value convergence. Patience is required to capture such opportunities, where the path to, and timing of, convergence is often highly uncertain. Further, long-horizon investors will inevitably suffer periods of poor performance. Patience will be tested, and its stock must be replenished. Against this background, we have provided suggestions for managing patience in the context of multi-layered investment structures. We recommend organisations build the stock of patience from the very start through: gaining organisation-wide buy-in; creating a long-horizon oriented investment process; hiring the right people; and building a long-horizon culture. The stock of patience then needs to be maintained by: working on retaining trust; offering the right incentives; framing performance in the context of long-term objectives; and showing leadership from the top.

We are not arguing that long-horizon investing is easy. Nor do we claim that it is the only way to generate strong investment performance. Or that it is appropriate for all. To the contrary, we suspect that genuine long-horizon investors will remain a minority, although we do hope that their number might grow. Nevertheless, long-horizon investing can be well worth the effort for organisations that manage on behalf of savers with long-horizon goals, and that are capable of positioning themselves to do so. For such organisations, we believe it is helpful to view the building then maintaining of a stock of patience as a primary challenge.

Appendix

Other papers by the authors on long-horizon investing:

Warren, Geoff. “Long-Term Investing: What Determines Investment Horizon?”, *CIFR Research Working Paper*, May 2014

Warren, Geoff. “Benefits (and Pitfalls) of Long-Term Investing”, *CIFR Research Working Paper,* October 2014

Warren, Geoff. “Designing an Investment Organization for Long-Term Investing”, *CIFR Research Working Paper*, October 2014

Neal, David and Warren, Geoff. “Long-Term Investing as an Agency Problem”, *CIFR Research Working Paper,* June 2015

Thinking Ahead Institute. “The search for a long-term premium”, May 2017

Thinking Ahead Institute. “Converting the 99 - Long-horizon investing beliefs”, September 2017

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- Find and connect people from all corners of the investment world and harnesses their ideas.
- Work to bring those ideas to life for the benefit of the end saver.

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- A dynamic and collaborative research agenda that encourages strong member participation through dedicated working groups.
- A global programme of events including roundtable and key topic meetings, webinars and social events.
- One-to-one meetings between Institute member organisations and senior representatives of the Thinking Ahead Group.

The solutions we collectively develop fall into three overlapping areas:

- Better investment strategies.
- Better organisational effectiveness.
- Enhanced societal legitimacy.

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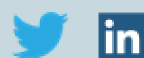

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