What you think, you become

Building a long-horizon mindset: a practical guide for asset owners

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Long-horizon investing working group

This document has been written by members of the Thinking Ahead Group 2.0 (Tim Hodgson, Liang Yin) 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
- **Daniel Godfrey**, The People's Trust
- **John Green**, Investec Asset Management
- **Leon Kamhi**, Hermes Investment Management
- **Michel Bernard**, Amundi Asset Management
- **Olivier Lebleu**, OMAM
- **Stephen Miles**, Willis Towers Watson

Other working group papers

"The search for a long-term premium" is our attempt to quantify value creation via long-horizon investing. It identifies eight building blocks (eg active ownership; liquidity provision; factor investing; avoiding forced sales). Together, they provide evidence of a sizeable net long-term premium of 0.5% to 1.5% pa depending on investors' size and governance arrangements. The paper was reported in the media and downloaded from the website over 2000 times.

"Converting the 99: long-horizon investing beliefs" argues that well-documented, smart (reflective of good insight) and edgy (reflective of competitive positioning) long-horizon beliefs are foundational to good long-horizon investment thinking. This correlates, ultimately, with better investment outcomes over the long term. The paper discusses the process of building strong beliefs and proposes nine core long-horizon beliefs for investors to consider and adapt.

The speed-read on what you need to do

Long-horizon investing is an attractive concept to asset owners. But without a long-horizon mindset to guide actions, it will remain just that – a concept. There are a large number of concrete steps asset owners can take to develop a long-horizon mindset and set themselves on a path to long-horizon investing. While all these steps have merit, some are easier to execute than others. So we group them into three categories:

Easy: **in many cases just a change of organisational habit**

Moderate: process change largely under internal control

Hard: process change likely requiring external help.

Strong organisation-wide long-horizon beliefs		
1	Agree, as an organisation, that long-horizon investing is worth undertaking – if you can't reach agreement, you can stop reading now	Easy
2	Carry out a process to develop smart (reflective of good insight) and edgy (reflective of competitive positioning) organisational beliefs regarding the "why", "how" and "what" of long-horizon investing	Hard
3	Ensure that these beliefs are validated, documented, embedded in the decision-making process at all levels and reviewed when circumstances and/or evidence sufficiently change	Moderate

Acute understanding of yourself and others		
4	Recognise your comparative advantages and disadvantages vis-à-vis various long-horizon investing approaches. Where no clear competitive advantage is identified, consider outsourcing or limiting exposure to that area	Hard
5	Conduct rigorous, forward-looking analysis of long- and short-term obligations. An accurate expectation of liquidity requirements is key to avoid becoming a forced seller in times of market stress	Moderate
6	Think liquidity management beyond meeting short-term cash-flow needs: long-horizon asset owners should consider actively increasing liquid reserves to exploit forced sales by other investors	Moderate

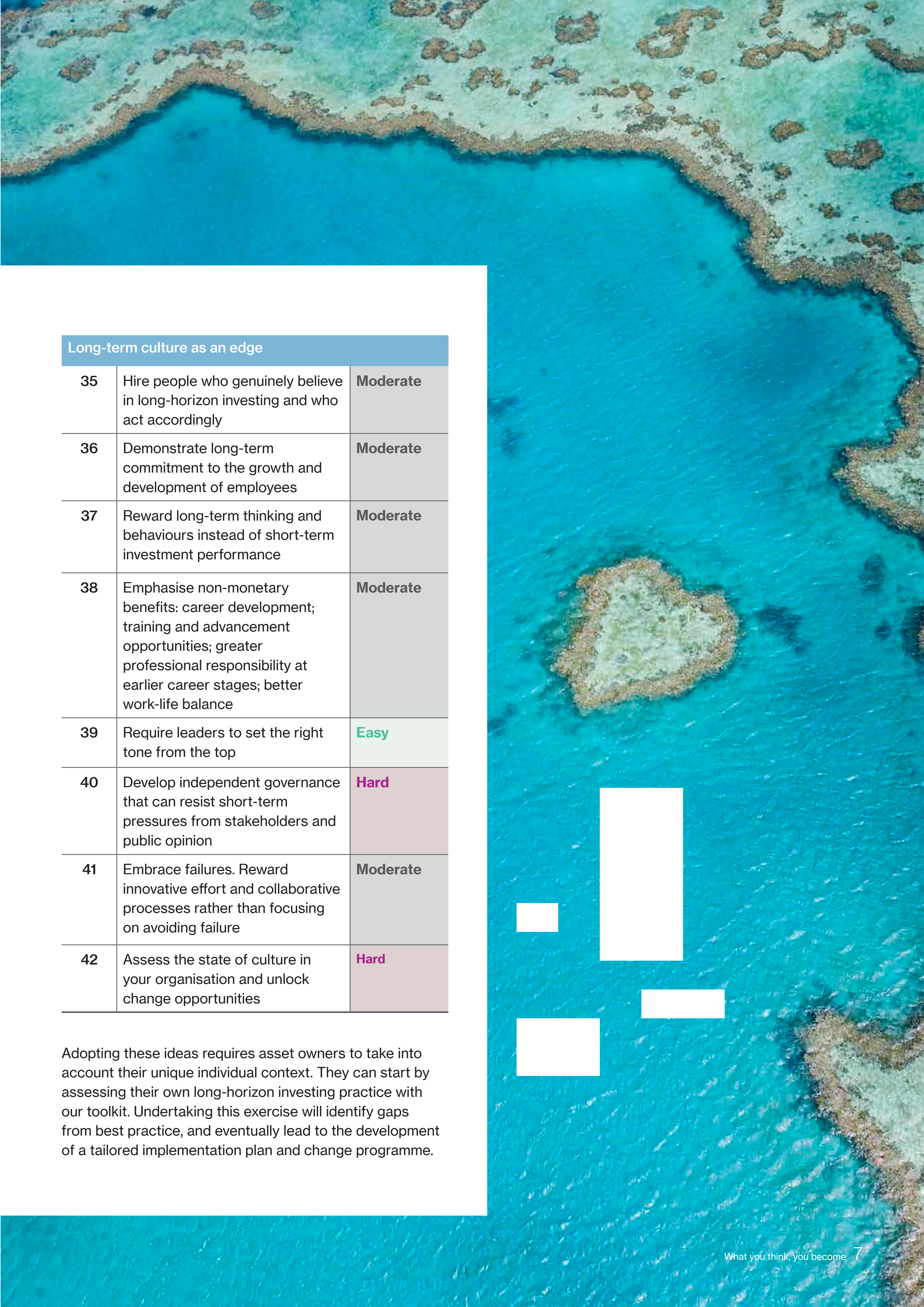
Effective long-term decision making		
7	Sometimes it is best to do nothing. Recognise the value of inactivity and evaluate investment performance less often	Easy
8	Recognise the importance of framing and presentation. Instead of asking “why should we be patient?” ask “why should we act?”	Easy
9	Focus on the inputs that encourage long-horizon thinking and deliberately look through what is used to gauge near-term price movement. For example, in an equity context, ignore earnings releases and concentrate on the company’s long-horizon cash flow generation potential	Easy
10	Complement human judgment with rules-driven processes (eg rebalancing), which are less prone to human bias and more governance-friendly	Moderate
11	Actively build cognitive diversity through team composition (eg look out for diverse thinking styles) and process (eg emphasise turn taking). Cognitive diversity typically leads to better decision making	Hard

Strong internal and external alignment		
12	Promote transparency to improve understanding and nurture trust. For example through thorough documentation of investment thesis and decisions	Easy
13	Clearly articulate and document a long-term mission; gain organisational buy-in to this mission	Moderate
14	Set expectations around short-term performance for the whole organisation – all ultimately successful long-term strategies underperform over short-term periods	Moderate
15	Develop deeper relationships with engaged partners, fostering a two-way flow of intellectual capital and better alignment	Moderate
16	Involve principals (eg board in board / executive relationship; asset owners in asset owner / asset manager relationship) in decision making to build understanding rather than maintaining independence and distance	Easy
17	Balance compensation between what is payable immediately and what can be deferred and subject to clawback in the event of poor long-term performance	Moderate
18	Consider paying a pre-agreed percentage of cumulative dollar-value created	Hard
19	Rethink variable pay: it does not necessarily create appropriate alignment	Hard

Focusing assessment and measurement on the long term, and on what matters		
20	Extend the term over which performance is measured – use rolling 7-year periods	Easy
21	Emphasise absolute over relative performance	Easy
22	If short-term performance must be presented, put it in a less prominent positon - start with 10-year rolling returns, followed by 7-year, 3-year and only mention 1-year performance as a "by the way..."	Easy
23	Develop statistical tests that screen out market noise. Focus performance evaluation on the key drivers of long-term returns – eg cash flows generated over the long run – while de-emphasising price fluctuations	Moderate
24	Focus the effort of measurement on what is material to long-term outcomes (eg qualitative, forward-looking skill ratings; strength of governance; effectiveness as an active owner; value creation) instead of what is easy to measure	Hard

Long-term approach to risk management		
25	Fundamentally shift the focus from managing volatility to avoiding mission impairment	Moderate
26	Diversify risk across time as well as across return drivers	Hard
27	Embrace tail-risk analysis and hedging – extreme risks matter to long-horizon investors. Consider both financial and non-financial risks	Moderate
28	Carry out long-term scenario testing, including a "pre-mortem" analysis, which is designed to ask: "if our organisation has failed in 20 years' time, what will have been the likely causes?"	Easy

Active and engaged owner mindset		
29	Act as if you, the asset owner, have a permanent stake in the healthy and sustainable development of the economy, society and environment	Hard
30	Collaborate with other like-minded asset owners to address resource challenges or use engagement service providers	Moderate
31	Engage with investee company board and management based on rigorous analysis	Moderate
32	Vote, from an informed position, on contentious issues	Moderate
33	Assist assets by providing further capital as appropriate	Moderate
34	Seek operational improvements in the management of your real assets	Moderate



Long-term culture as an edge		
35	Hire people who genuinely believe in long-horizon investing and who act accordingly	Moderate
36	Demonstrate long-term commitment to the growth and development of employees	Moderate
37	Reward long-term thinking and behaviours instead of short-term investment performance	Moderate
38	Emphasise non-monetary benefits: career development; training and advancement opportunities; greater professional responsibility at earlier career stages; better work-life balance	Moderate
39	Require leaders to set the right tone from the top	Easy
40	Develop independent governance that can resist short-term pressures from stakeholders and public opinion	Hard
41	Embrace failures. Reward innovative effort and collaborative processes rather than focusing on avoiding failure	Moderate
42	Assess the state of culture in your organisation and unlock change opportunities	Hard

Adopting these ideas requires asset owners to take into account their unique individual context. They can start by assessing their own long-horizon investing practice with our toolkit. Undertaking this exercise will identify gaps from best practice, and eventually lead to the development of a tailored implementation plan and change programme.

Introduction – what's on your mind?

The working group's first paper[1] suggested that a sizeable net long-term premium (0.5%-1.5% pa) can be exploited by investors with the appropriate mindset and skillsets.

We felt that it was natural to start with the question whether long-horizon investing is even worth undertaking. Because if we cannot be at least reasonably certain that we will be rewarded, then why bother? The next question we asked ourselves was: where should investors start on this journey?

We settled on a set of strong long-horizon beliefs, shared across the entire organisation and applied in decision making at all levels[2]. The investment industry operates in an environment without a solid theoretical foundation. So investors have no choice but to use beliefs as a long-term compass to guide investment decisions.

Having beliefs is just the first step. This, third, paper addresses many more aspects that asset owners can work on to think, and consequently behave, like a long-horizon investor.

It proposes a number of ideas to guide asset owners towards a long-horizon mindset. It encompasses our interpretation of what a long-horizon mindset might mean, and some practical steps for building it. As a way of grouping, we pack these ideas under eight headlines.

[1] *"The search for a long-term premium"*, Thinking Ahead Institute, 2017
[2] *"Converting the 99: long-horizon investing beliefs"*, Thinking Ahead Institute, 2017

1. Strong organisation-wide long-horizon beliefs

As in our previous paper, well-documented, smart (reflective of good insight) and edgy (reflective of competitive positioning) long-horizon beliefs are foundational to good long-horizon investment thinking. This correlates, ultimately, with better investment outcomes over the long term. For reference, figure 1 lists the nine core beliefs we proposed for investors to consider and adapt.

"...long-horizon beliefs are foundational to good long-horizon investment thinking."

Figure 1 – **Thinking Ahead Institute long-horizon investing working group beliefs**

1. The competitive edge for long-horizon investors i determined by their ability (skill-sets) to identify long-term opportunities and their willingness (mindset) to maintain their position in the face of inevitable short-term underperformance.
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 precess.
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 is critical to the success of long-horizon investing.
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.

2. Acute understanding of yourself and others

Recognise comparative advantages and disadvantages

While we believe there are benefits to appropriate collaboration, asset owners typically operate in a competitive environment. They compete for talent, resources, intellectual capital and in many cases investment returns[1]. Put simply, long-horizon asset owners need to evaluate exactly where their competitive advantages lie. And that is done by understanding internal capabilities, and their strengths and weaknesses in each area. The investment philosophy and process for capturing the long-term premium should be framed by reference to these comparative advantages. Where no clear competitive advantage is identified, asset owners should consider outsourcing or limiting exposure to that area.

Build extreme clarity about liabilities and obligations

Rigorous, forward-looking analysis of long- and short-term obligations is key to avoid becoming a forced seller in times of market stress. During the GFC, some sovereign wealth funds focused their investments inward to stimulate their slowing economies, despite few apparent short-term liabilities. Some endowments and foundations found that they had underestimated short-term liabilities to external managers, such as calls for committed capital from private equity funds. In order to meet these obligations, they had to realise losses in their portfolios[2]. It demonstrates the challenges in accurately expecting liquidity requirements.

Manage liquidity beyond meeting short-term liabilities

Liquidity management should extend beyond the analysis of short-term cash-flow needs. In times of market stress, seemingly liquid assets can become highly illiquid, forcing investors to sell at deep discounts. Perceived diversification benefits may evaporate as "correlations go to one". On the other hand, strong liquidity management is not just good risk management practice. It can be a source of better returns. Long-horizon asset owners may consider actively increasing liquid reserves to exploit forced sales by other investors. Sidebar 1 describes the work New Zealand Superannuation Fund undertook in this area.

[1] This is certainly true for picking active managers – competing for alpha – although in a later session on active ownership we will argue that asset owners can (and should) collaborate to improve the market beta via helping investee companies focus on the long term.
[2] *"The Future of Long-term Investing"*, World Economic Forum, 2011

Sidebar 1 – **New Zealand Superannuation Fund (NZ Super) case study**

NZ Super is a long-horizon fund that has been very active, and successful, in generating a long-term mindset. It exploits this comparative advantage through a number of investment strategies and most materially by acting as a contrarian investor (via its strategic tilting programme). To avoid being forced to sell assets during times of stress, NZ Super needs to be highly confident that it will have the risk appetite and liquidity available during these times. It specifically calibrates its risk appetite and liquidity to be able to buy risky assets during times of stress. Without such a calibration NZ Super runs the risk of being "stopped out" in times of stress which can significantly impair the profitability of its strategies and strategic tilting in particular. NZ Super is clear that unless stakeholders are confident that this will unlikely happen (ie that they are truly a long-horizon investor), they should not engage in strategic tilting.

To achieve this calibration of risk tolerance and liquidity use, NZ Super models and monitors a balanced score card that includes portfolio flexibility, ie the potential for the portfolio to withstand a significant downturn in asset prices and market liquidity conditions. This modelling includes an anticipation of the contrarian investments that would be desirable under these conditions, and verifies that there is not an unacceptable threat of mission impairment*. Where portfolio flexibility is considered low, a disciplined framework is used to make 'budgeting' judgements as to which of the investment opportunities (the users of risk and liquidity) should be not pursued or if necessary scaled back, so as to dynamically manage the risk of abandoning a strategy in a stressed market event.

* NZ Super's mission is, inter alia, to maximise return subject to not incurring undue risk.

3. Effective long-term decision making

Build barriers to cognitive biases that drive short-horizon behaviours

Daniel Kahneman, a psychologist who won an economics Nobel Prize, has a theory of how human brains think and make decisions[1]. Our cognitive processes, as Kahneman suggested, are divided into two distinct systems. System 1 is heuristic thinking – a fast, autonomous and often unconscious way of thinking, prone to biases and systematic errors. System 2 is reasoned thinking – a slower, harder and controlled way of thinking that normally kicks in when faced with complex problems.

One of the System 1 biases is called myopic loss aversion. This happens when investors over-focus on the short term and monitor performance too frequently. As a result, they may react too negatively to recent losses and lose sight of long-term goals. We propose a number of remedies to these heuristic biases:

- Recognise the value of inactivity and evaluate investment performance less often. Entrench infrequent feedback and thus fewer opportunities to take action[2]. See sidebar 2 for an insightful example from Taleb[3]
- Shift the focus of reporting from short-term metrics to long-term outcomes[4]
- Encourage team decision-making – this reduces the effects of myopic loss aversion, as teams are believed to behave more strategically than individuals[5]
- Recognise the importance of framing and presentation. Instead of asking "why should we be patient?" ask "why should we act?"[6]
- Complement human judgment with rules-driven processes, which are less prone to human biases and are more governance-friendly. A strict rules-based rebalancing approach is a robust way of institutionalising contrarian behaviour[7]. It is important that the procedure cannot be arbitrarily changed during times of stress. With a supportive governance structure and capability, asset owners can even improve the rebalancing rules by including valuation-based metrics to capture mean reversion. This can lead to more aggressive purchasing of assets with a more attractive risk/return profile after a major sell-off.

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1 *"Thinking fast and slow"*, Daniel Kahneman, 2011

2 See *"The effect of myopia and loss aversion on risk taking: An experimental test"*, Richard Thaler, Amos Tversky, Daniel Kahneman and Alan Schwartz. The Quarterly Journal of Economics, 1997 and "A long look at short-termism", Michael Mauboussin and Dan Callahan, 2014

3 *"Fooled by Randomness (The hidden role of chance in the market and in life)"*, Nassim Nicholas Taleb, 2001

4 *"Myopic loss aversion and the equity premium puzzle"*, Shlomo Benartzi and Richard Thaler, Quarterly Journal of Economics, 1995

5 *"Are teams prone to myopic loss aversion? An experimental study on individual versus team investment behavior"*, Matthias Sutter, Economics Letters, 2007

6 *"Overcoming short-termism: mental time travel, delayed gratification and how not to discount the future"*, Kym Irving, Australian Accounting Review, 2009

7 *"Investing for the long run"*, Andrew Ang and Knut Kjaer, 2011

Sidebar 2 – **always on? Switch off!**

We consider a dentist (an unimportant, but colourful detail) setting up a trading room in his attic – perfectly rational behaviour, as he is a truly outstanding investor. He is able to outperform short-term bonds by 15% pa, albeit with a volatility of 10% pa. He, therefore, has a 93% probability of making money in any one year, which would keep most of us happy. Unfortunately, our dentist has subscribed to a real-time data feed and he watches the value of his portfolio every second. The very same statistics tell us that he now only has a 50.02% probability of being ahead that second. Increasing the time horizon to a minute improves the odds to 50.17%. What does that really mean? Well, assuming he spends eight hours a day in front of his screen, he will have 241 pleasant minutes against 239 unpleasant ones. Not only will our dentist be emotionally drained by the end of each day from the sheer volatility of the ups and downs, but we also know, from behavioural finance, that he will feel the losses far more keenly that any boost he gets from gains. Our dentist will simply not survive this emotional onslaught, and heaven forbid, may even be tempted to change the portfolio (which if left alone has a 93% chance of finishing the year ahead).

It is quite clear from this hypothetical example that high frequency performance measurement carries a high emotional cost, and it is difficult to distinguish between noise and signal. The conclusion, with respect to monitoring the performance, is that there probably isn't much value in knowing – certainly not with the frequency we would like.

Focus on the inputs that encourage long-horizon thinking

We believe there are two relevant questions for any investment proposition: (1) *if* there will be a positive payoff and (2) *when* will that positive payoff occur. Long-horizon investors need not be too concerned with *when* the payoff might arrive. They absolutely should worry *if* it will occur. To answer the *if*, the focus is on identifying divergence between prices and values. Answering the *when* requires a very different set of inputs. It is about predicting the evolution of market phycology ie where the price might go next.

Similarly, John Kay puts forward the idea of "value discovery"[1]. In the context of equity investment, this means trying to establish the nature and sustainability of the long-term competitive advantage of a business. On the other hand, the idea of "price discovery" is based on the understanding of order flows and the expectations of other traders.

This way of thinking makes a clear distinction between the inputs that favour long-horizon thinking and those that favour short-term thinking. Figure 2 expands on this. Our suggestion for want-to-be long-horizon investors is: deliberately choose your inputs.

Figure 2 – **focus on what encourages long-horizon thinking**

Inputs for long-horizon thinking	Inputs for short-horizon thinking
☐ Long-term cash flow generation potential: sustainability of competitive advantage; emerging competition; brand loyalty	☐ Flow of immediate results – how earning might compare with market expectations; and the likely market reaction.
☐ Sustainability of the financial and economic system and wider society and environment; licence to operate.	☐ Short-term profitability
☐ Long-term transformational changes.	☐ Market perceived winners and losers as a result of the current theme.
☐ The extent to which demand / supply mismatch creates mispricing opportunities.	☐ Momentum: how demand / supply mismatch drives near-term price movements.
☐ Extreme risks matters – events that are very unlikely to occur (in the short term) but could potentially 'kill you'.	☐ Short-term price volatility.

Source: John Kay, Geoff Warren[2] and authors

[1] *"The Kay review of UK equity markets and long-term decision making"*, John Kay, 2012
[2] *"Designing an Investment Organization for Long-Term Investing"*, Geoff Warren, 2014

Assemble a skilful investment team rich in cognitive diversity

Institutional investing is all about group decision making. We view cognitive diversity as an important concept for long-horizon investing, as under most circumstances it will improve investment decision making. When long-horizon investors inevitably experience short-term adverse performance, a team rich in cognitive diversity can support non-consensus views and the willingness to go against the crowd. It can also lead to information-processing advantages and greater cognitive resources (skills, perspectives, knowledge, and information)[1]. 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 staying on course becomes a straightforward decision. Where the assessment points to changes in fundamentals, long-horizon investors should be prepared to change course – they are not buy-and-hold investors. Either way, cognitive diversity improves the success rate of long-horizon investment.

Decision-making groups with diverse thinking styles are also found to be less vulnerable to overconfidence. This can manifest itself in over-trading and overweighting risky positions – neither of which is compatible with long-horizon investing.

Diversity is often viewed through surface characteristics – such as gender, race, and age. Diversity is more impactful when it is intrinsic, innate to an individual's values, perspectives, knowledge, experiences and ways of thinking. In a team setting, cognitive diversity is attained through team composition and process.

However, diversity is not completed without inclusion and integration. There is a balance between promoting cultural unity and groupthink. Highly diverse teams with poor integration tend to underperform. We suggest that patterns of working should be set early on, and good integration can be fostered by introducing appropriate behavioural checklists.

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

4. Strong internal and external alignment

Promote transparency

Long-horizon investing intensifies the difficulty of aligning agents, both internal and external. Adrian Orr, the CEO of the New Zealand Superannuation Fund, suggests that full transparency is the route to mitigating the agency problems that inevitably arise in the management of other people's money[1].

Transparency allows stakeholders to understand and build confidence and trust in the decision-making processes, which is particularly valuable during times of short-term underperformance. Some suggestions for transparency include:

- thorough documentation of major investment decisions and of the underlying supporting investment thesis;
- regular updates to stakeholders of operational and investment failures and successes[2], and
- demanding full transparency on the fees charged by investment managers[3].

Gain organisational buy-in to a clearly articulated long-term mission

A strong buy-in to a long-term mission across all levels of the organisation is one of the key foundations to becoming a long-horizon investor. This is difficult, particularly because of multiple stakeholders[4].

The mission statement needs to be clearly articulated and documented. In practice the primary goal is likely to be augmented by supporting goals. The aim is to marshal the thinking and actions of all stakeholders to align with the mission.

Communicate effectively and manage expectations

A clear mission allows the creation of objectives and guiding principles. These need to be communicated clearly and frequently to secure support across the organisation.

GIC, the Singaporean sovereign wealth fund, believe that the right words engender the right attitudes and, in turn, the right behaviour. The wrong words can corrode and even corrupt the process, so they aim to be meticulous. For example, they prefer "sustainable results" to "consistent results". They avoid emphasising short-term performance. They would correct anyone in their organisation who used the phrase "the long-term is but a series of short-terms"[5].

Expectations around short-term performance fluctuations should be carefully managed. Simply put, all long-horizon investors experience periods of adverse performance. Decision makers are less likely to react inappropriately if this expectation is fully embedded within the organisation.

A study examined 145 international equity funds and discovered that the funds with the highest 15-year returns all underperformed the index and their peers significantly over short periods[6]. All of them showed up in the worst decile for at least one quarter. Eight out of the top 15 appeared in the worst decile at least once, sometimes for as long as three years. The study concluded that short-term underperformance is "as normal as death and taxes" and an inherent by-product of the long-term investment process.

Better incentive design

A fit-for-purpose design of fees and incentives is central to addressing misalignment. The challenge is to balance long-term goals with the pressure to reward agents in the near term in a competitive labour market. While there are a few helpful ideas for asset owners to consider (see below), we believe this is an area that requires further in-depth research and some (radical) changes in practice before we can claim it is fit for purpose.

- Balance the compensation between what is payable immediately and what can be deferred and subject to clawback in the event of poor long-term performance
- Bonuses, if used, to be reinvested in parallel portfolios that invest alongside the main fund, ensuring risks are shared[7]
- Fees as a pre-agreed percentage of cumulative dollar-value created over the life of investment mandates[8]
- Debate the efficacy of variable pay: it does not necessarily create appropriate alignment despite its wide adoption[9]

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[1] *"Perspectives on the long term"*, Focusing Capital on the Long Term, 2016
[2] It is very important to distinguish between successes / failures and short-term out / underperformance. Successes or failures are defined in the context of progress towards long-term investment objectives. Figure 3 demonstrates clearly that we should not bombard stakeholders with short-term market noises.
[3] *"Innovations in Long-Term Capital Management: The Practitioner's Perspective"*, World Economic Forum, 2016
[4] *"Best-Practice Investment Management: Lessons for Asset Owners from the Oxford-Watson Wyatt Project on Governance"*, Gordon Clark and Roger Urwin, 2007
[5] *"Perspectives on the long term"*, Focusing Capital on the Long Term, 2016
[6] *"Death, Taxes and Short-term Underperformance: International Funds"*, The Brandes Institute, 2014
[7] *"The Future of Long-term Investing"*, World Economic Forum, 2011
[8] *"Fees get another rethink"*, Tim Hodgson, 2017
[9] *"To bonus or not to bonus?"*, Tim Hodgson, 2016

Develop deeper relationships with engaged partners

Deeper relationships enable ideas to flow in both directions. Trust develops, costs are aligned to interests, and economics of scale and scope can be achieved. We believe that long-term partnering relationships between asset owners and asset managers support higher and more sustainable investment returns.

Before we leave this section, we refer to a paper co-authored by David Neal, CEO of Future Fund, and Dr Geoff Warren from Australian National University for more insights on the subject of achieving alignment[1]. Figure 3 is our summary of the key takeaways from the paper.

Figure 3 – **summary of "Long-Term Investing as an Agency Problem" By David Neal and Geoff Warren**

Ceding agency for asset management creates information asymmetries and alignment issues

- Difficult to distinguish between signal and noise in performance
- Short-term monitoring adopted as a heuristic for manager ability and accountability

These issues make it difficult for both asset managers and assest owners to embrace true long-term investing

- Achieving a long-term mindset requires overcoming career risk and commitment issues

Potential solutions for asset owners:

- Create a shared understanding of the long-term goal
  - Embedding long-term investing within the organisational mission, purpose and beliefs
  - Building a culture of professionalism, trust and acceptance of non-consensus stances
  - Establishing clear objectives, with a long-term focus
  - Employing the right people
- Build stakeholder understanding through communication, transparency and engagement
  - Engagement means involving principals in decisions, rather than maintaining independence and distance. In other words, governance can overlap with management which contradicts with the conventional wisdom that there should be clear separation between the two. The paper claims that it is a necessary compromise for long-horizon investing – if principals don't understand investment decisions, they are prone to managing according to short-term performance noise
- Design incentives to promote long-term focus while retaining scope for ongoing review
  - One solution is to regularly award bonuses that are accrued on an ongoing basis, but only subsequently vest and are paid conditional on performance being sustained
  - Another solution is to include a subjective component in the incentive award system that is explicitly used to reward long-term focused behaviours
- Commit to long-term holdings with asset managers

[1] *"Long-Term Investing as an Agency Problem"*, David Neal and Geoff Warren, 2015

5. Focusing assessment and measurement on the long term, and on what matters

Reduce the frequency of monitoring and focus performance measurement on long-term goals

As mentioned earlier, frequent measurement of performance is likely to lead to wear and tear on emotions and subsequent value-destructive actions. Investors are simply better off ignoring short-term performance information. Instead, they can adopt a few simple alternatives:

- Extend the term over which performance is measured: we advocate using rolling 7-year periods as a principle evaluation period for a long-term equity mandate[1] (see figure 6 for more on a long-term measurement framework). The Future Fund measures itself against a target return of CPI + 4.5%-5.5% over 10 years. The key investment metric for GIC is a 20-year rolling real rate of return across the entire portfolio. New Zealand Superannuation Fund models its expected return and risk over a time horizon of 30 years
- Emphasise absolute over relative performance. While we recognise the role of a supporting benchmark (eg an equity index) to reflect an asset manager's opportunity set and assess their execution ability, the primary performance measure for long-horizon investors should be an absolute return target (eg CPI + x% pa). Further, we would prefer monitoring to focus on the money-weighted return which is more consistent with end savers' goals
- If the desire to present short-term performance is too strong, put it in a less prominent position. For example, start with 10-year rolling returns, followed by 7-year, 3-year and only mention 1-year performance as a "by the way..."

[1] *"Long-term mandate strawman",* Thinking Ahead Institute, 2016

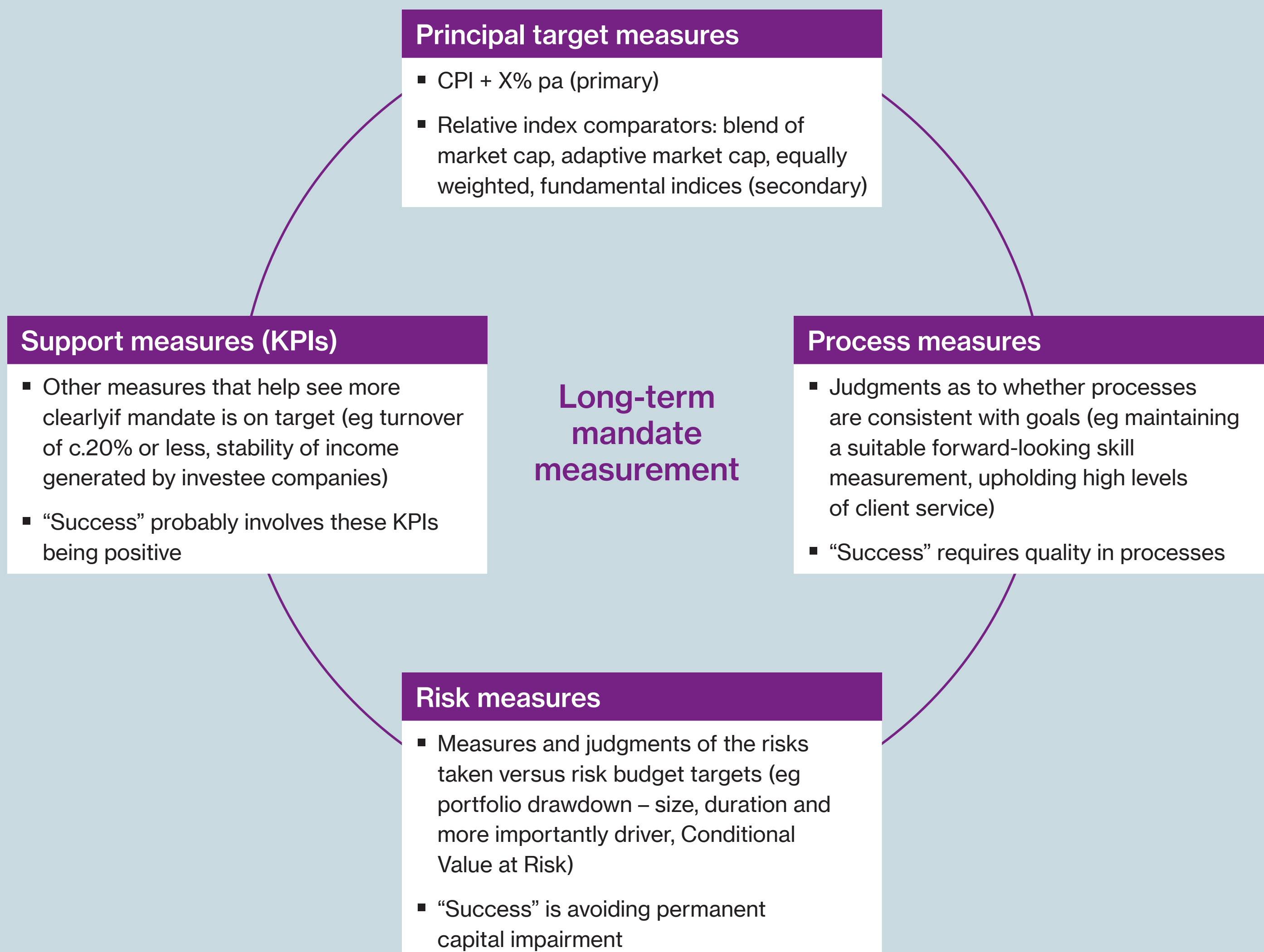


Figure 4 – **balanced scorecard approach for long-term mandate measurement**

Develop statistical tests that screen out market noise

The noise in performance data can be spectacular. Better statistical tests need to be designed so as not to draw erroneous conclusions from data with high noise levels. These tests can be pre-specified with agreed confidence intervals, and should be flexible enough to evolve as we collect more data. Willis Towers Watson has developed a framework using a Bayesian approach to update beliefs about the future performance of an investment manager, in light of the active performance that has been produced[1].

Performance evaluation for long-horizon investors should focus on the key drivers of long-term returns – cash flows generated over the long run – while de-emphasising price fluctuations arising from other sources. Figure 5 shows an approach that decomposes long-term returns into three components: initial expected return, variations in expected return and variations in expected cash flows as well as a case study of a leading asset owner following a similar approach in practice.

[1] *"Evaluating an Investment Manager in an Uncertain World"*, Robin Penfold, 2012

Figure 5 – **Focus on fundamental drivers of long-term returns**

An academic contribution

Geoff Warren (CIFR)* proposed an approach to decompose long-term realised returns into three components:

1. Initial expected return
2. Variations in expected return
3. Variations in expected cash flows

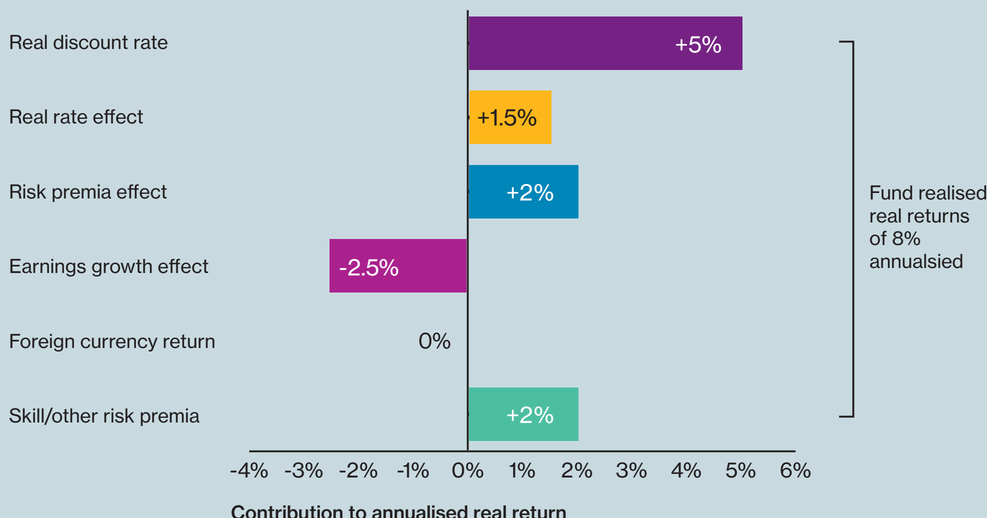
"The aim is to position the key driver of long-term returns **– cash flows generated over the long run...** as the **central focus** of the investment process. This is facilitated by both establishing long-term expected excess returns as the basis of portfolio construction; and then reinforcing the focus through **emphasizing the initial expected return and cash flow innovation components** of the return attribution when evaluating performance. Meanwhile, **re-pricing effects** related to changes in discount rates are **de-emphasized...**"

Future Fund case study

The Future Fund developed a framework for analysing the drivers of investment returns, establishing linkages between the macro-economy and the way that asset values are determined by markets as a set of discounted cash flows. This framework enables the Future Fund to better assess the efficacy of both its investment strategy and its implementation. It decomposes long-term returns into:

1. Expected real discount rate at the start of the period
2. Changes in the underlying constituents of real discount rate
3. Changes in earnings/cash flows
4. FX effect
5. Skill and other idiosyncratic risk premia

Macro factor contribution to total fund annualised real return since 1 July 2009

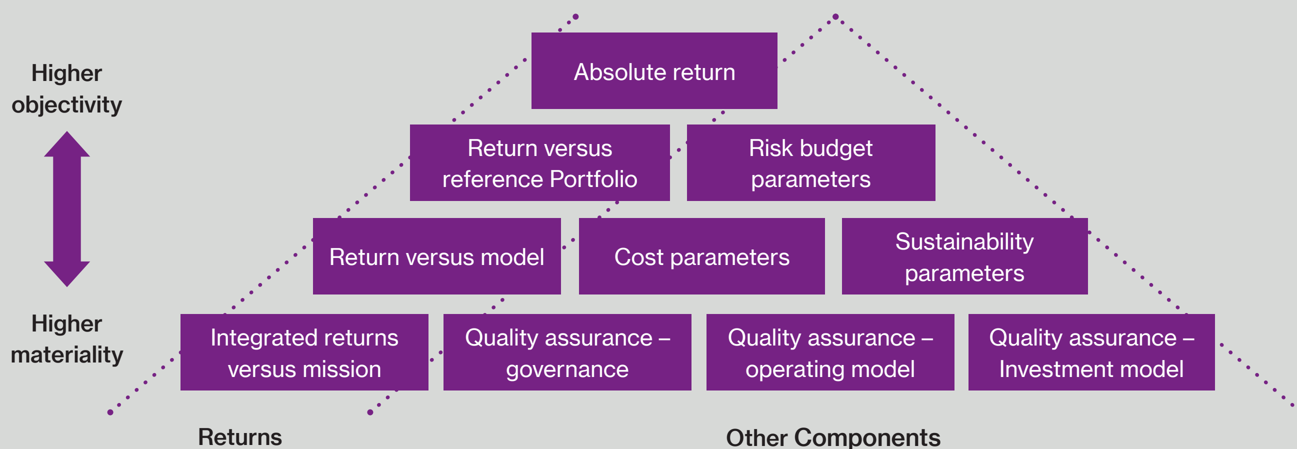


Source: *"Portfolio construction and performance evaluation for long-term investors"*, Geoff Warren, 2015 and Future Fund annual report 2015/2016

Figure 6 – **A framework for good measurement**

Good measurement is about striking a healthy balance between:

- Multiple measures – a balanced score-card
- Returns and other components
- Objectivity and materiality – 'soft' in narrative and 'hard' in measurement



Source: *"Smart leadership. Sound followership."* Future Fund and Willis Towers Watson asset owner study, 2017

Measure what really matters

When it comes to measurement, there is often a trade-off between objectivity and materiality. For example, an absolute return measure over a short time period is entirely objective while arguably not material for long-term outcomes given the noise issues alluded earlier. On the other hand, an assessment of investment governance capability or culture is material but highly subjective. Figure 6 sets out a framework for good measurement.

Therefore, we encourage long-horizon investors to step out of the comfort zone of relying on high-objectivity and yet low-materiality measures for monitoring. They should incorporate subjective assessment alongside objective performance data, in a balanced score card (figure 4). While there are numerous potential measures to consider, it is advisable to focus limited governance resources on a small number of carefully-selected ones, perhaps drawn from the following list:

- Consistency of execution with the investment beliefs and thesis
- Consistency of philosophy and long-term ethos
- Qualitative, forward-looking skill ratings (for both internal and external asset managers)
- Style consistency
- Stability of team
- Turnover and cost. Measurement of these is objective, but subjective interpretation is required in assessing whether they are appropriate
- Assessment of governance
- Assessment of team culture
- Assessment of business model
- Diversity "score"
- Effectiveness as active owner (eg voting record)
- Assessment of value creation using the integrated reporting framework.

Monitoring is hard work. Our experience is that with the passage of time, assessment tends to get narrowed down to a single relative return metric. Qualitative assessment is even harder work, calling for strong governance.

6. A long-term approach to risk management

Move the focus from managing volatility to avoiding mission impairment

For asset owners to create wealth and deliver missions, some risk needs to be taken. Risk has many facets. When a long time horizon applies we argue that risk should be defined in terms of failing to achieve the mission[1]. For example, misestimating long-term cash flows leads to overpaying for an investment, resulting in permanent loss of value.

Diversify risk across time (as well as return drivers)

A long time horizon also creates opportunities for time diversification. When endowed with a long time horizon, asset owners should think about diversifying risk across time as much as across return drivers at a point in time. In practice, it is about focusing more on money-weighted returns (or internal rates of return) instead of time-weighted returns.

Embrace tail-risk analysis and hedging – extreme risks matter to long-horizon investors

Extreme risks are events that are unlikely to occur (and therefore infrequent) but that have a significant impact on economic growth and asset returns, should they materialise. Over a long time horizon these events become more likely and so need to be part of a long-term, holistic risk management practice ("Given enough time, very low probability events not only can happen, but they absolutely will happen" – Lloyd Blankfein, CEO, Goldman Sachs). For long-horizon asset owners, the emphasis of tail-risk management is about avoiding mission impairment. Extreme risk events include the functioning of capital markets, political and social issues, and sustainability issues including environmental threats and license to operate[2].

Carry out long-term scenario testing

Asset owners must grapple with the potential impact of long-term forces on their portfolios. A scenario-testing framework can help. A recommended practice is the pre-mortem analysis, which is designed to ask the question: "if our organisation has failed in 20 years' time, what will have been the likely causes?" This question facilitates deep discussion on potential threats and increases the likelihood that they are identified and, as a result, can be mitigated or managed.

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[1] *"Risk Management Revisited: The Wrong Type of Snow"*, Thinking Ahead Group, 2012
[2] *We wrote a paper on extreme risks in 2013 and intend to update it in 2018.*

7. Active and engaged owner mindset

Don't just passively own – aspire to create new wealth

Long-horizon investors have an opportunity to develop long-term relationships with investee companies. This can be done through both their active and index-tracking holdings. A long time horizon is viewed by many asset owners as both an advantage and a responsibility. This recognises that stewardship is a duty performed on behalf of beneficiaries with the potential to improve returns.

Instead of being passive recipients of returns via reshuffling claims on existing wealth, long-horizon asset owners should seek to proactively identify and support new sources of wealth creation. This is consistent with the mindset of investing in the world as if the asset owner was here to stay forever. In other words, genuine long-horizon asset owners see themselves taking a permanent stake in the healthy and sustainable development of the economy, society and environment. They should therefore act accordingly.

Engage

Whether directly or in collaboration with others, long-horizon asset owners can build deeper relationships with investee companies, and influence long-term value creation. There are various ways to act collectively – the International Corporate Governance Network, Investor Forum, Canadian Coalition for Good Governance, and so on. Active ownership pre-supposes a deep knowledge about the fundamentals of the companies (or assets) and may then entail[1]:

- Informed voting on contentious issues
- Providing bespoke capital for investee companies
- Private equity co-investments – make direct investments via private deals
- In real estate or infrastructure, seeking operational improvements to the asset's management.

Sidebar 3 develops a case study based on real-world practice of acting as an active owner.

[1] *"Perspectives on the long term"*, Focusing Capital on the Long Term, 2016

Sidebar 3 – **case study: active ownership at Hermes Investment Management***

For over 20 years, Hermes have acted as a responsible owner for the investments it manages and stewards on clients' behalf. At the heart of their stewardship approach has been the objective of aligning the actions of investee companies, other investments and policymakers with the long-term interests of the beneficiary investor. Hermes' stewardship activity covers a range of topics from business purpose, capital allocation and risk management to environmental, social and governance matters.

Governance is the bedrock. It is a critical role of the board to get this right as it provides the foundation for how an organisation's executives are incentivised to behave. Beyond this, each industry has its own set of issues. For example, for bank investee companies the engagement priorities are corporate culture, business conduct, business portfolio and loan policies relating to climate change. In contrast, for extractives companies, health & safety, energy mix, potential for stranded assets and impact on local communities including human rights are key.

Where Hermes are the 100% owner they manage these matters directly. In real estate for example, they work with their agents to improve energy efficiency, reduce carbon emissions, provide construction apprenticeships and enhance the place in which the buildings are located through the mix of occupiers (residential, commercial, educational…) and the open spaces developed.

Engagement has its greatest impact if carried out at board level and in a two-way, constructive dialogue. The investor should be ready to put forward her views and, if she believes them to be right, use the full rights at her disposal to pursue them. Engagement should be focused on specific objectives in the context of the organisation's needs and challenges. This requires a different experience and skillset than that often found within portfolio management.

Hermes' stewardship business, Hermes EOS, acts on behalf of investors as an overlay. Stewardship has a key role to play whether as part of a passive or active investment strategy. For a passive fund, engagement is arguably the only way it can add value to its investments and fulfil the investor duty of stewardship.

For an active fund, engagement, whilst beneficial as an overlay, is most effective as an integrated part of the investment process. When integrated, engagement, as well as encouraging an organisation to act in the investor's interests can also provide forward-looking insights to the materiality of risks and opportunities. With the right skillset, engagement can be carried out by a specialist engager or a fund manager or, perhaps is most powerful when in combination.

The benefits of engagement go beyond the investment return. Through engagement with policy makers, standard setters and asset holdings, externalities such as climate change can be addressed, benefits of greater diversity in the workforce achieved and bribery & corruption curtailed. If effective, alongside a pension income, this will generate a sustainable economy which beneficiaries can afford and want to retire in.

**This case study is provided by Leon Kamhi who is Head of Responsibility at Hermes Investment Management, and a member of the long-horizon investing working group. The views and opinions contained herein are those of the author and may not necessarily represent views expressed or reflected in other Hermes communications, strategies or products.*

8. Long-term culture as an edge

More and more investment organisations have recognised the importance of a strong culture, especially for asset owners who strive to be long-horizon investors. So what is culture?

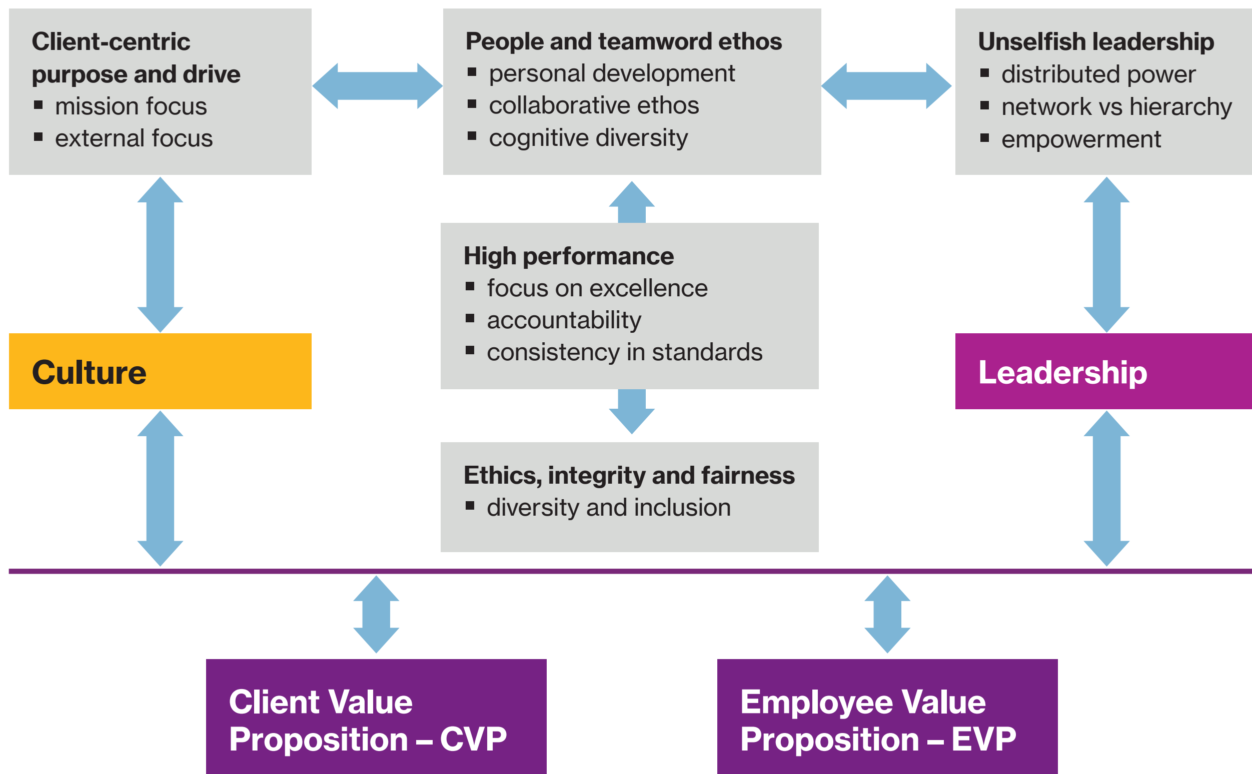
Think genetic code in DNA. It is a set of procedures that define the development and function of living organisms. Similarly, culture is the written and unwritten organisational "code" that defines "the way we do things around here". It is the collective influence from shared values and beliefs on the way the organisation thinks and behaves[1].

Culture is so all-encompassing that inevitably many of the aspects discussed earlier are also elements of culture: focusing on the mission; nurturing trust; building cognitive diversity in team composition; seeking alignment via incentive design and so on. In this section we therefore focus our suggestions on ideas that have not yet been covered. Building a long-term culture is about embedding long-horizon investing into the organisational DNA:

- Hire people who genuinely believe in long-horizon investing and who act accordingly. We explored earlier using extrinsic (monetary) incentive design to encourage the right behaviours. But frankly, no incentive arrangements can realistically change a short-horizon investor into a long-horizon investor. The key is therefore to find the right people from the get-go. The tendency to "do the right thing" (as opposed to just "doing things right") should be a prominent criteria in hiring. For example, this includes the willingness and ability to challenge the consensus position
- Once the right people are hired, the organisation needs to demonstrate long-term commitment to their growth and development. One of the challenges is that 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. This mismatch can be, at least partially, addressed by encouraging longer tenures
- When it comes to assessing and rewarding people, the key is to reward long-term thinking and behaviours instead of short-term investment performance, which is inherently noisy. Emphasise non-monetary benefits: career development; training and advancement opportunities; greater professional responsibility at earlier career stages; better work-life balance
- Leaders are hugely influential in the creation and evolution of culture. Good leaders recognise that left to its own devices culture declines overtime and therefore actively work to maintain it. They lead by the example they set, what they choose to focus on, and what they are not willing to tolerate. They seek a deliberate alignment of culture to long-term strategy and take every opportunity to advocate the importance of a long-term approach. They engage in building peer-to-peer relationships and mutual respect with the board. In times of underperformance, this relationship ought to provide a buffer and enhance understanding. They strive to build an environment where career risk is low – it is ok to "look wrong"
- Encourage continuous learning and detecting failure early on[2]. Long-term investment can fail and a robust operational process can facilitate a rapid impact assessment. Incentive structures should be designed to reward innovative effort and collaborative processes rather than focusing on avoiding failure.

If we can circle back to the dilemma of measurement, culture is one of those areas that might be too difficult to measure but also is too important to ignore. We believe what gets measured gets managed. As a result, we built a culture assessment toolkit (see figure 7) for investment organisations to understand themselves more accurately and unlock change opportunities[3].

Figure 7 – **model for culture assessment**



[1] *"The impact of culture on Institutional Investors"*, Roger Urwin, 2015
[2] "Innovations in Long-Term Capital Management: The Practitioner's Perspective", World Economic Forum, 2016
[3] One TAI member, AMP Capital, undertook this assessment in 2016 and gave very positive feedback. Please get in touch with any member of TAG if you would like to know more about it.

Conclusion – from mindset to practice

"We choose to go to the moon in this decade and do the other things, not because they are easy, but because they are hard…"

John F. Kennedy

Long-horizon investing is hard in practice. As Keynes said "There is a peculiar zest in making money quickly". That is probably why it is so rewarding, and will continue to be rewarding. This paper attempts to take a practical approach to creating a long-horizon mindset, with implementable ideas and concepts which can be readily adapted to individual asset owner organisations. The list of these potential ideas is almost intimidatingly long (42!) – congratulations on making to the end! It will be even harder, a lot harder, to implement them in practice. But hopefully our previous research has demonstrated that it will be worth the effort.

So how should an asset owner implement these ideas? They will need to consider their unique context and constraints before they can develop a tailored implementation plan and change programme. We have built a gap-analysis toolkit to help measure an investor's true time horizon[1] and identify what needs to be improved. We encourage asset owners to undertake this exercise to start their individual journey of bridging the gap between the attractive concept and desirable outcome of long-horizon investing.

Finally, to emphasise the practical nature of these ideas, we have taken GIC's approach to long-horizon investing and matched it to our proposed structure for a long-horizon mindset (figure 8). We invite you to develop your own version.

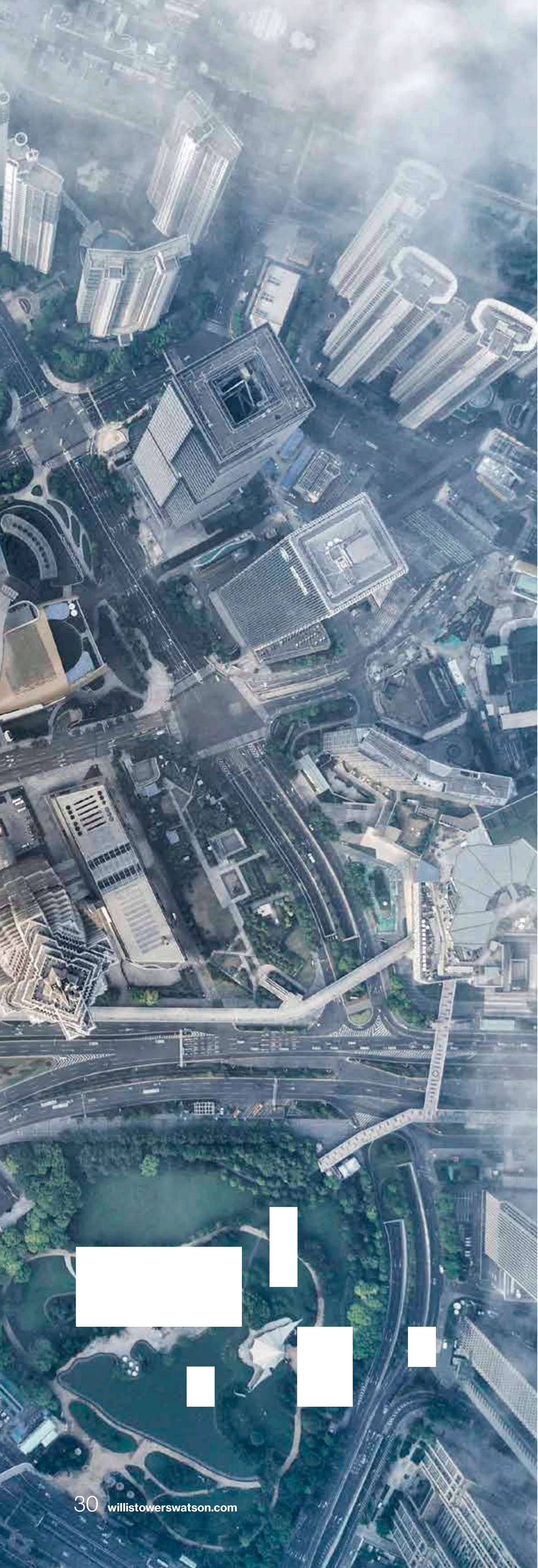
[1] Please contact Liang Yin if you think your organisation might be interested.

Figure 8 – **Case study: GIC's long-term approach fitted to our proposed structure**

1. Long-horizon beliefs	2. Understanding of yourself and others	3. Decision making	4. Alignment
"At the heart of GIC's investment philosophy is our value discipline. We look for the compounding of fundamental value and opportunities in price-value divergence." "...we are prepared to wait longer for the convergence than most investors."	"A willingness to forgo short-term gratification and keep faith with the fundamentals... has been at the heart of our mission since the beginning of GIC." "...it is critical to look beyond stock prices to actual business performance. When done well, this is a source of competitive advantage."	"...is actually not the time horizon that matters most, but rather the mind-set and discipline to consistently invests based on fundamentals... in particular... in the face of market fluctuations and uncertainty..." "Marks to peers can be a powerful (and damaging) psychological driver of flawed decision making."	"...addresses potential agency problems through clear approval authority, regular reporting, and separation of conflicting roles." "Clear statements on the return objective, risk capacity, and scope of authority give fund managers the confidence to construct the best portfolios..." "Communication is important to surviving the long and bumpy ride."

5. Measurement	6. Risk management	7. Active owner mindset	8. Culture
"At the aggregate-portfolio level, the 20-year-rolling real rate of return the key investment metric for GIC." "The minimum time horizon for performance measurement is five years." "Differentiating process from outcome...evaluating performance at the total portfolio level"	"Our approach to risk management is multi-pronged: 1. managing portfolio investment risk 2. legal, regulatory and compliance risks 3. tax risk 4. operational risk 5. counterparty credit risk 6. reputational risk and 7. people risk." "The multi-pronged approach... ensures that risks...are looked at in a comprehensive manner."	"We have also extended the advantage into the area of providing bespoke capital for investees. Our long-term and flexible capital has added to our opportunity set."	"Senior management takes every opportunity to advocate the importance of a long-term approach...there can be no doubt about our seriousness regarding these issues." "We emphasize long-termism in career development." "Our HR focus on making GIC one of the best places in the world to practice long-term investing."

Source: GIC's Long-Term View, Lim Chow Kiat (CEO), *"Perspectives on the long term",* Focusing Capital on the Long Term, 2016; *GIC Annual report 2016-2017*



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.

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.

The contents of individual documents are therefore more likely to be the opinions of the respective authors rather than representing the formal view of the firm.

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