

# Long-term investing in public equity markets: what does success look like...and how to organize it?

February 2018



Jaap van Dam



Lars Dijkstra

Views expressed here are those of the authors, who is solely responsible for any errors and omissions.

---

## Introduction

---

In 2015, fifteen Dutch CIOs of asset owners and asset managers wrote an article with the title: 'Short-term profit or long-term value creation?' A growing group of pension funds, asset managers, consultants and companies worldwide try to answer this question.

The core aspects of long-term investing are the following: you pay attention to **value creation**, the potential to create strategic value with the companies you do or do not invest in; so you think **fundamentally** about investing; your portfolio has focus and therefore invests in far fewer companies than in the entire market; you invest with patience; you are involved, you act as an owner; you pay attention to the **societal impact** of the company, for example CO<sub>2</sub> emissions. The benchmark then has a completely different, more of a free role than what's currently the case when investing in public equity markets.

This paper is a practical next step following the article of the CIOs. We try to be as concrete as possible, and we go from 'why' to 'how'. The 'how' of long-term investing has two major challenges, namely (1) how to *minimize* the principal-agent problems around long-term investments, and (2) how to *maximize* the impact on the companies in which you invest. We mainly focus on the first challenge and discuss four practical topics in this article:

- (1) What does success look like?
- (2) How to organize long-term investments well? How to regulate governance?
- (3) How to shape mandates and how to monitor progress?
- (4) How to give the asset manager the right incentives?

We see the pension fund as the party that seeks to organize long-term investments well, in the interest of its participants.

Whilst this paper is for an international audience, we realize that there may be international differences between, for example, the views on sustainability or societal effects.

---

## 1. What does success look like?

---

When is a long-term investor successful? When can one proudly say: I did well? In this section, we give practical bases for this. In our opinion, there are three things that matter:

1. The net long-term return (so after all the costs)
2. The risk involved
3. The contribution to societal objectives (more important to some than others)

We distinguish two possible frameworks, namely (1) an **absolute framework**: a direct relationship with the long-term (return) objectives of the outsourcing pension fund (for example: inflation + 3%), or (2) a **relative framework**: establishing a relationship with the simple alternative for long-term investing, namely the market as a whole. In practice, we also encounter combinations of the two.

(Ad 1) An **absolute framework**. An absolute framework has many advantages. After all, if the central risk of a pension fund is not achieving the long-term return goals, then there is a direct relationship with this assignment. The overall objectives of a fund and the liability structure determine the long-term return required. These could be based for example on the owner's adjusted discount rate plus an equity risk premium, a  $\text{libor} + x\%$  or a  $\text{CPI} + y\%$  target.

(Ad2) A **relative framework**. In practice, not many outsourcers choose a purely absolute framework. In order to achieve their goals, they find a simple and cheap alternative in passive investing in, for example, the global equity benchmark. In this context, success can be defined as follows: realizing with a minimum horizon of let's say seven years...

- a net return that is at least as high as that of the benchmark;
- at a risk that is at most equal to that of the benchmark and;
- achieving a greater contribution to societal objectives (e.g. one or more Sustainable Development Goals) than in the benchmark.

What is important in the success definition to sustain through the entire investment value chain is that the role of the benchmark is completely different here than in active management. In active

management, the benchmark – often the market index – is the reference; everything that deviates from it is ‘risk’. So, think relatively. And often on a short-term. The route to your goal is therefore the benchmark, and if you see opportunities you deviate from the benchmark and that deviation is called risk.

This fundamentally differs from long-term investments; you know the route of the benchmark, but you outline a fundamentally different one. Both in advance and during the journey, you must be able to explain why this is a better route than the standard route, despite the fact that others usually choose a different one, that of the benchmark: ‘your capital will pay off better in the long run’; ‘the portfolio is more resistant to shocks than the benchmark’; ‘CO<sub>2</sub> emissions are lower’. You have to be able to do this looking forward – ex ante – and back – ex post, and that requires quite something. The risk definition is therefore not about relative risk or tracking error, but rather about absolute risks. We will talk about this in the third part of this article.

This argumentation must be firmly substantiated. A “trust me” approach will not and should not do in an institutional context. After all, what makes this asset manager recognize that opportunity successfully, where the market as a whole doesn’t see it? And so solid that the long-term strategy will remain intact, even in setbacks.

---

## 2. The governance of long-term investment

---

Long-term investment is the outsourcing of an investment mandate with a lot of degrees of freedom and a long horizon. As a long-term investor, you do something fundamentally different than the average market participant, which can be highly uncomfortable. It’s not easy to receive interim feedback about whether the chosen strategy will actually be successful, nor whether the asset manager is able to do so successfully. As Michael Mauboussin says: “Saying it somewhat differently, the feedback loop is not very tight in financial markets.”

This leads to a principal-agent problem that requires a lot from both the outsourcer and the one to whom is being outsourced. Of the outsourcer, so ultimately the pension fund board: the conviction and the confidence that both the long-term strategy and the manager will deliver in the longer term. Of the one to whom is being outsourced: the confidence that the outsourcer actually has the endurance that is needed to successfully execute the strategy and not pull out the plug, in case of disappointing results. Otherwise, the executive asset manager will tend to move towards a benchmark after all.

There is a lot of evidence that even in ‘normal’ active mandates with a strong benchmark orientation, managers are fired for the wrong reasons and at the wrong time after a few years of underperformance. So apparently, it’s not easy to properly organize

this long-term trust, and to provide insight into the portfolio and the approach: show me instead of trust me.

### Long horizon between dream and action: find the weakest link

The total outsourcing chain of a typical pension fund is long: the participant, with a very long horizon, outsources to the pension fund – that is often managed with a much shorter horizon. The fund outsources to a fiduciary manager or a consultant – often with a contract that needs to be renewed about once every five years. The fiduciary manager or a consultant outsources to one or more asset managers. Between the long horizon of the participant and the long-term investment by the asset manager, there are thus a number of parties with a much shorter horizon. These parties have an interest in not reporting any setbacks on the horizon that is relevant to them. In this way, the one in the chain with the shortest horizon determines the horizon of the entire chain. But as pension funds need to serve the long term interests of the participant, it’s important to reduce these problems.

### Are those principal-agent problems solvable?

The problems mentioned can be addressed to a considerable extent, but they require constant attention and maintenance, which asks for a serious effort.

Below is a list of elements that can reduce the problem:

- **Success starts at the front.** If the asset owner, the pension fund, does not have the deep desire to be a long-term investor and reap the potential benefits, the chances of success are small. This requires explicit long-term goals and a good idea of the possible interim results.
- A solid set of **investment beliefs** that almost has the character of a constitution that ties in with long-term investments. For example: in the long term, the return and the risk of an investment are determined by the profits and cash flows of the underlying company. As long as they show the desired growth, we are less concerned about the short term volatility of the share price.
- **The right measures for long-term and interim success and monitoring.** Over the past decades, the market price and the index have become the standard benchmarks for monitoring and risk management. Reporting is about the ‘deviation’ of the index and the ‘active risk’ and ‘active return’ as a result of this deviation. This view distracts from what really matters to long-term investing, namely fundamental measures for long term value creation of the investments, such as earnings growth, cash flows, dividends and intrinsic value. Putting these types of measures at the center of the monitoring enables the right conversation. Short-term market price-related measures are not relevant and distract from this. Private equity doesn’t have them either!
- **A short chain between asset owner and asset manager.** The above has made clear that the link in the chain with the shortest horizon in fact determines the horizon of the investments. The

shorter the chain, the smaller the chance of this type of links. For this reason, we advocate internal management by the pension fund – provided that, of course, it can organize the associated competencies – or for external management by a party that is very close to the outsourcer in culture and investment beliefs.

- **Constantly building shared insight into process, outcomes and trust.** By continuously conducting a dialogue between the fund and the manager about the way the process works, why the portfolio is as it is, and so on, mutual understanding and trust are strengthened and the short-term risk of damage is reduced. ‘Being known is being loved.’ This also argues for a short chain. David Neal calls this ‘immersed monitoring’<sup>3</sup>. It helps a lot when fundamental investment knowledge is present in the board of trustees or the investment committee.

---

### 3. How do we shape a long-term mandate and how do we monitor progress?

---

What can such a long-term mandate look like in practice, given the importance of good governance? We use four P’s: Philosophy, Performance, People and Price. In this section we discuss the first three, the last section is about Price and incentives.

#### a) Philosophy

In the area of investment beliefs, a deep-seated alignment between the asset owner and asset manager is crucial. ‘Beliefs’ should preferably be a constitution, and the core of the constitution is that the focus in the portfolio is on the companies instead of the shares. This may sound trivial, but it certainly isn’t. Over the past thirty years, the vast majority of the financial industry has become obsessed with trading in shares instead of investing in companies. Or as John Kay expressed it in his Review for the British government (2014): “There is a clear distinction among asset managers between those who *invest* on the basis of their understanding of the fundamental value of the company and those who *trade* based on their expectations of likely short-term movements in the share price. Long-term investors manage these deviations with patience rather than trying to time them. Long-term investment strategies must be more concerned with long-term risk of loss than short-term volatility.”

In ‘Patient Capital Outperformance’, Cremers and Pareek (2016) show that only asset managers who have a very long-term horizon, a low turnover in their portfolios and a concentrated portfolio of companies outperform their peers materially on all relevant operational metrics as well as long-term total returns (2.3% per annum). Furthermore Khan, Serafeim and Yoon (2015) show even bigger outperformance of companies who focus on corporate sustainability. Harford, Kecskes and Mansi (2015) show that

the portfolios of asset managers with a long horizon are mainly invested in companies with high-quality boards, who spend more on innovation, have higher returns on capital, higher dividend pay-outs, lower take-over defenses and lower financial leverage. Hence, these and other studies find logical connections between good fund governance, good corporate governance, long-termism focused decision-making and superior corporate financial results. Importantly for investors, short-term focused financial markets continued to be surprised by these superior financial results. This in turn means that long-horizon investing, expertly executed, continues to generate material excess investment returns.

The investment process of asset managers should therefore focus on long-term industry trends on the one hand, and building a concentrated (focused) portfolio of companies within those on the other hand. The development of the intrinsic value of these companies over time is one of the most important metrics in our view. By intrinsic value we mean one or more measures of the value creation by the company. Hence, focus on the quality and the operating metrics (cash flows, return on capital, R&D, net margins and WACC) of companies instead of their share price metrics.

To improve the long-term value creation of companies, portfolio managers need to maximize their impact through engaged active ownership. This means portfolio managers must act as engaged owners of the companies they invest in. Via constructive challenge of corporate management, the long-term financial returns and the sustainable returns can be improved. In this way, long-term shareholders can also make sure that companies act in the interest of all stakeholders. As shown by Kahn and others improving the financial and non-financial long-term results more often than not go hand in hand. This requires, however, shareholders who act as active owners. A view shared already for a long time by the former UK Treasurer Lord Myners in his criticism of the Ownerless Corporation.

#### b) Performance and risk measurement

As discussed, the performance objectives can be defined both absolutely and relatively by the asset owner. Given that the current state of the industry is to relate all investment results to the market benchmark, this will in practice be one of the most difficult elements in monitoring a long-term mandate. Although we have a preference for an absolute framework, we can imagine that having multiple metrics can have a liberating effect, especially in the first years of such a mandate. The performance of long-term mandates should preferably be measured over at least a seven-year horizon. The interim result is composed of a number of measures on a scorecard. For example, the change in intrinsic value can be reported. Additionally, the portfolio return can be compared on a five-year rolling basis with a relevant market benchmark.

Warren Buffet, a long-term active owner, has used such a metric for years to compare his own performance with. Other highly relevant measures could be the non-financial but sustainable goals of the asset owner. For example, reducing the CO2 emissions of the portfolio by 50%, creating more alignment in the long-term incentives of the management of the companies with those of the shareholders (i.e. the asset owners), create more equal pay between top management and the median income in the company or contributing to the realization of specific UN Sustainable Development Goals. Especially scrutinizing the impact of the investments of a company on the possible positive impact on society in the long term is just as interesting in this respect as measuring the current revenues. Most important has always been to show both ex ante and ex post that, based on these characteristics, you have a portfolio in which you get (more) value (growth, value, stability, sustainability) for money as compared to the benchmark, and that this will eventually also result in a higher and/or more stable return that matches the portfolio's goals.

A fundamentally different view is also required when measuring risk. As Peter Drucker once summarized beautifully: "What gets measured gets managed". And so, the traditional short-term measures of risk that measure the volatility of share prices are not very meaningful. We propose a number of risk measures that provide a better insight into the risks of operational development of the companies in the portfolio. What is the probability that this intrinsic fundamental value development and the expected cash flows will not materialize as predicted? Scenario analysis of a number of important profit and value drivers are then important. The real risk of the asset owner is not meeting his long-term objectives. Permanent loss of capital is then a much more relevant measure, or e.g. the absolute Value at Risk. Alternatives are the deviation between the intrinsic value development of the portfolio versus the long-term objective. Obviously, risks can and must be spread by diversifying cash flows across various companies, sectors and regions.

### c) Reporting and monitoring

As the above shows, the establishment of a long-term mandate is of a very different nature than a traditional active mandate. The monitoring of such a mandate also requires a fundamentally different approach. As mentioned, whether the asset manager is on the right track requires a constant building of a shared insight into process, results and trust. In addition to all sorts of quantitative measures, the story that goes with the portfolio is also an important aspect here: why is this company in the portfolio? Under what conditions do you expect the portfolio to perform worse than the market in the short term? And when better?

What else can we say about the monitoring of such a mandate? First of all, that this will be less frequent and less focused on the market prices of share prices than the traditional reports. We think that a monitoring report aims to provide insight into...

- the realized **progress** on the objectives;
- the **activities and turnover** that have taken place in the portfolio;
- the current **characteristics** of the portfolio to show the logic of meeting your objectives in the future;
- the **attribution** of the portfolio return over a long period/the reporting period, in order to show that the building blocks of the strategy ultimately achieve the intended goal, so e.g. that selecting companies with higher economic value creation ultimately translates in higher returns.

So, the question is which metrics do we want to use? Of course, the long-term value development of the portfolio measured at a much lower frequency, e.g. on a quarterly or semi-annual basis. The development of the underlying operational metrics of the companies in the portfolio such as cash flows, margins and thus intrinsic value is important. The long-term value creation can in our view be well summarized by a concept as intrinsic value. If the price of the share differs strongly from the intrinsic value development of the company, a 'patient' investor will also have good opportunities for long-term value creation.

We also find it useful when 'soft' measures are reported on the portfolio, such as an assessment of the quality of the management of the companies invested in, or the extent to which the companies commit themselves to achieving environmental and social goals.

In addition, the asset owner will be able to measure the process discipline of the asset manager against metrics such as holding periods and turnover ratio.

Finally, a look-through analysis of the entire portfolio of companies is relevant. We thereby distinguish between a report on long-term macroeconomic and **industry trends** on the one hand, and **sustainable development trends** on the other. It's therefore about providing more insight into the financial risks as well as the non-financial risks. In his role as a shareholder, the asset manager can be expected to maximize his influence on the companies. Depending on the assignment of the asset owner, it can therefore also explicitly concern the interests of all stakeholders and not just those of him as a shareholder. Of all companies in the portfolio, both the ESG risks and opportunities must be identified. It is thereby important that the asset manager maps out the efforts (input) and the results (output) of his engagement for all companies in the portfolio.

### d) People and Culture

It will not come as a surprise that the culture of the asset owner and of the asset manager play a very important role in both the selection and the monitoring of the asset manager. In order to minimize the principal agency issues (or organize a short chain), the asset manager must have developed a strong, long-term culture that is aligned in all respects with the long-term mandate that

the client has in mind. For example, an employee-owned asset manager (a partnership) with focus is generally more focused on the long-term than a listed asset manager with a broad spectrum of products and clients. Other examples showing the long-term commitment of the asset manager are portfolio managers who have invested a substantial part of their capital in their own company or in their own fund. Obviously, long lock-ups must apply for this. ‘Skin in the game’ and ‘Eat your own cooking’ at least for the full duration of the mandate is a potential part of alignment between asset managers and their clients. Furthermore, the people who run the mandate should be very seasoned, innovative, patient, passionate and long-term committed professionals. The team should be a diversified group of characters and skill sets. Hence, we strongly prefer people who are experts on industry trends, know how to run companies above people who know how to trade securities. This requires a fundamental different set of skills than most people in the financial industry have. We like to call this a modern craftsmanship, which resembles a strong culture and aligned professionals. See also an interesting CFA paper titled ‘The Future State of the Investment Profession’ (2017) which addresses the education challenge.

---

## 4 The 4th P: Price (and incentives): how to stimulate the asset manager in the right way?

---

Before making remarks about incentives and alignment, we want to emphasize the following. Incentives are often overestimated. Incentives can help the right people, in the right culture, to do the right thing. But in our opinion, incentives can never compensate for the lack of the right people or the right culture. Financial incentives are thus at the most a means of strengthening the already agreed alignment in goals and approach.

Nevertheless, the whole of price and incentives that contribute to the alignment between asset owner and asset manager is an important part of a long-term mandate. Having said that, we want to emphasize that we have a strong preference for simple fee structures.

Also here we advocate a different business model than the mainstream investment management agreement. The mainstream fee models can be broken down into three models:

1. Fixed fee: the fee is ignorant of portfolio size and performance.
2. Flat fee: the fee is changing linear with the AuM of the mandate. In many cases the flat rate changes when certain size thresholds are passed.
3. Performance fee: these come in several ways, but most common is the flat fee rate depending on the level of (out-)performance.

In the long-term mandates the traditional fee structures will give too much focus on short-term relative performance and may lead to high fees in early years.

Much more alignment should be created between the asset owner and the asset manager over time. This can be done in several ways. Owners can commit to a longer-term relationship by handing out long-term mandates. Decelerating management fees and accelerating incentive fees can provide owners with better alignment and may be possible with the commitment to a lock-up period that gives managers more stability. Either fee structure for a long-term mandate should create space for patience and reduce the need to try to time market prices.

Practical examples of long-term fee structures could be:

- A low fixed fee that covers the basic costs of an asset manager for the next seven to ten years. Basically, a cost-plus approach which can be a fixed annual amount in euros or a flat number of bps, but in this case much lower than a traditional active mandate (for example 30 bps).
- The asset owner and asset manager can also combine the low fixed fees with more aligned performance fee models. For example, a x% participation rate above a hurdle rate which relates to the owners’ long-term goals. The performance fee could be paid out only after seven years and with high watermark afterwards. Deferring the performance fee, rather than paying it and clawing it back in the case of underperformance, lessens the possibility that the manager will become overly risk averse during the later years of the contract. Other examples of variable fees could be symmetrically capped with a minimum and maximum around a fixed fee.
- Another logical enhancement is to have a loyalty discount. This can be a lower fee than normal at the start of the long-term mandate or a discount to the existing fee after for example five to seven years. The longer the mandate runs the cheaper the fixed management fee will become.
- Another option could be to lower the fixed fee for all clients the larger the asset pool of the long-term strategy of the manager gets (the Vanguard model). This would align very well with the investment philosophy; the bigger the strategy assets will be, the bigger the impact of the engaged long-term shareholder will be on the underlying companies. In a concentrated portfolio this works very well.

As mentioned, financial incentives cannot bridge a difference in investment beliefs and culture. Asset owners could also have more of a say in the design of the investment process and the team that will manage their mandate. In this way, the owner is more in control and a partner instead of a customer. Being known is being loved.

---

## Conclusion

---

Shaping and monitoring a long-term mandate requires a substantial investment of both asset owners and asset managers in terms of time and energy. The traditional principal-agent

issues can to a large extent be limited or resolved. Long-term investing requires knowledge, trust and continuity, and is therefore certainly not suited for every pension fund. On the other hand, according to the authors' conviction, there is a result that is expected to be better and more stable in the longer term than a passive investment in the benchmark, and at the same time a more positive influence on society. That makes it well worth thinking about.

### Footnote:

1. The section on governance has been published in a slightly different way in the Financial Investigator under the title: "Lange Termijn Beleggen: Let op de governance!" by Jaap van Dam, May 2017.
2. This article is partly inspired by conversations with Coos Luning and Jaap van der Geest (TKPI), Richard Klijnstra (KCM) and Felix Lanter (PGGM).

### Literature:

- 1) Lars Dijkstra et al., 'Short term profit or Long Term value creation?', VBA Journaal najaar 2015.
- 2) Jaap van Dam: 'Lange Termijn Beleggen: Beter voor pensioenfondsen én maatschappij', Financial Investigator May 2016.
- 3) Jim Ware et al., 'High Performing Investment Teams', John Wiley & sons, 2006, p. viii.
- 4) David Neal and Geoff Warren, 'Long-Term Investing as an Agency Problem', June 2015.
- 5) Martijn Cremers and Ankur Pareek, 'Patient Capital Outperformance', 2016.
- 6) Kay Review Recommendations for the UK Government, John Kay 2012 and 2014.
- 7) Khan, Serafeim and Yoon, 'Corporate Sustainability; First Evidence of Materiality', 2016.
- 8) Harford, Kecskes and Mansi, 'Do long-term investors improve corporate decision-making?' 2015.
- 9) CFA Institute, 'The Future State of the Investment Profession', 2017.
- 10) FCLTGlobal: 'Institutional Investment Mandates: Anchors for long-term performance', 2017.
- 11) McKinsey Global Institute: 'Measuring the economic impact of short-termism', 2017.





---

## The 300 Club

---

The 300 Club is a group of leading investment professionals from across the globe who have joined together to respond to an urgent need to raise uncomfortable and fundamental questions about the very foundations of the investment industry and investing. The mission of the 300 Club is to raise awareness about the potential impact of current market thinking and behaviours, and to call for immediate action.

Current economic and investment trends will change the investing landscape over the next two decades and we are at a crisis point which presents huge risks to investors, according to the 300 Club. Moreover, the 300 Club believes that current financial and investment theory and practice run the risk of failing investors at their time of greatest need.

[www.the300club.org](http://www.the300club.org)

---

## Contact us

---

For further information about the 300 Club, contact our Media Team:

*Jean Dumas*

+44 (0) 20 7680 2152

[jean.dumas@the300club.org](mailto:jean.dumas@the300club.org)

The views and opinions contained herein are individual views held by those of the 300 Club. The information herein is believed to be reliable but the 300 Club does not warrant its completeness or accuracy. No responsibility can be accepted for errors of fact or opinion. This material is not intended to provide and should not be relied on for accounting, legal or tax advice, or investment recommendations. This document is published solely for informational purposes and is not to be construed as a solicitation or an offer to buy or sell any securities or related financial instruments. Although the 300 Club believes that its expectations and the information in this document were based upon reasonable assumptions at the time when they were made, it can give no assurance that those expectations will be achieved or that the actual results will be as set out in this document. The 300 Club undertakes no obligation to publicly update or revise any forward-looking information or statements.

PR00293 0002952