



Winning the long-term game – new insights into asset owners' behaviour and their interactions with asset managers

A workshop hosted by the Mistra Sustainable Investments Platform

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onValues Ltd.
July 2009

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"An investor is aiming, or should be aiming, primarily at long period results, and should be solely judged by these. The fact of holding shares which have fallen in a general decline of the market proves nothing and should not be a subject of reproach. It should certainly not be an argument for unloading when the market is least able to support such action."


— *John Maynard Keynes*

Background — as if the long term really did matter...

The basis for the workshop was the hypothesis that, even as increasing numbers of institutional investors accept that a broader range of investment drivers¹ must be considered in order for them to meet their long-term objectives, the 'apparatus' that they use to implement their investment strategies remains ill-suited to the task.

The apparatus in question includes asset owner governance, the methods by which the performance of asset managers is measured, the incentives included in investment management agreements and the general operating environment created by the owner through his communications and actions. More broadly, we also consider behavioural biases that can encourage decisions that are sub-optimal in the long term.

The range of strategies adopted is illustrated by a real-life example presented at the workshop (below), which shows the investment objectives articulated by two large institutional asset owners, both of which have a stated focus on the long term.



Same objective, different 'apparatus'

- Two large funds (net assets > EUR 2bn)
- Both with vocal commitment to long-term investment and to integration of ESG issues

Fund A	Fund B
<ul style="list-style-type: none">▪ Investment objective: a return that seeks to out-perform a fixed benchmark▪ All performance targets are relative (except private equity) and evaluated on an annual basis	<ul style="list-style-type: none">▪ Investment objective: average return \geq inflation+5% per annum▪ Long-term average return measured over rolling 5-yr. periods▪ Risk assessed by reference to downside outcomes over rolling 3-yr. periods (not tracking error)

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Source: Gordon Hagart, onValues

We believe that the ongoing financial crisis makes the workshop particularly timely, given the increased scrutiny of governance both within asset owners and at the companies they own, and the doubts being raised by some investors about the viability of long-term, buy-and-hold approaches to risky asset classes. Above all, levels of trust between beneficiaries and their fiduciaries and between asset owners and their asset manager agents are at historic lows.

The workshop addressed the challenges of the asset owner–manager relationship in two stages:

1. Understanding how investors take decisions, how they are influenced by prevailing beliefs, and which behavioural biases are most dangerous for the long-term investor
2. Presenting and refining better long-term models for the asset owner–manager relationship

¹ Including environmental, social and governance (ESG) issues

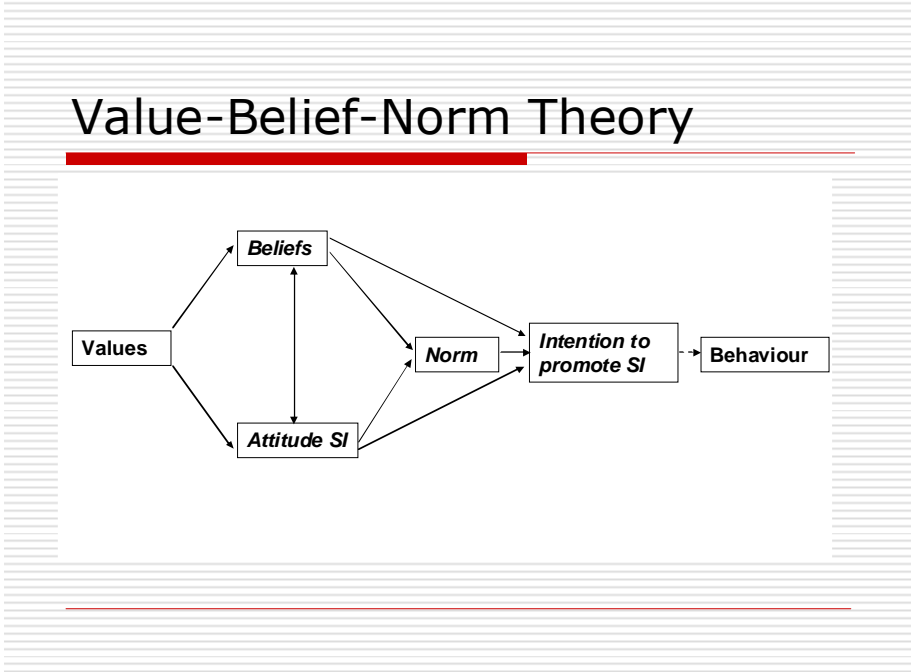
As a starting point for the discussions, we presented participants with a number of hypotheses on better models for long-term investment in advance of the workshop. These hypotheses and links to supporting research can be found in the appendices on page 11.

Selected insights from the workshop

In the following sections we present a summary of the key points made during the workshop's plenary and break-out sessions. The workshop was conducted under the Chatham House Rule, and as such the points are not attributed to individual participants.

The behaviour of asset owners

- The likelihood of an investment organisation changing its behaviour to better accommodate long-term investment practices is crucially dependent on the culture of the organisation. Notably:
 - ➔ To what extent do the values and norms of the organisation support a longer-term approach?
 - ➔ To what extent is there agreement on those values and norms — do they 'permeate' the organisation?
- Empirical research into how investors' beliefs about long-term and ESG-inclusive investment affect their behaviour has been carried out by the University of Gothenburg. The research bases its understanding of investor behaviour on the 'value–belief–norm' theory set out below



Source: Anders Biel, University of Gothenburg
Note: SI = sustainable investment (ESG-inclusive investment)

- The University of Gothenburg research has so far revealed that values and norms supporting long-term behaviour are much more prevalent at asset owners and at the CEO level of organisations than at asset managers or among the 'rank and file' of investment professionals

- The catalysts for moving towards longer-term practices vary depending on whether the investor already has taken some steps towards longer-term investment models or ESG-inclusive investment
 - ➔ Where some activity already exists, 'social' factors such as the positive opinions of peers, research analysts and beneficiaries on long-term investing and ESG are most likely to encourage further changes in this direction (the investor is looking for 'safety in numbers')
 - ➔ In contrast, where the investor has no long-term / ESG pedigree, no amount of social factors is likely to change his behaviour. In such circumstances regulatory pressure is the most likely catalyst for a change in behaviour
- Participants agreed that, without a clear codification (e.g. in the statement of investment principles) and internal and external communication of the asset owner's beliefs around long-term investing and ESG, the ability of the investor and its agents to move towards a longer-term outlook is severely reduced

Better models for the asset owner–manager relationship

The majority of the workshop was dedicated to discussing possible changes to the traditional relationships between asset owners and their asset managers that could support a longer-term approach to investment. We took a broad definition of 'relationship', to include statements of investment beliefs and objectives, how the asset manager reports to and is measured by the owner, the remuneration and other incentives hard-wired into the investment management agreement, and the softer elements of the relationship created by ongoing contacts between the owner and manager.

Participants were asked to prepare suggestions for changes to the way owner–manager relationships are structured, which were then debated during the workshop's break-out sessions. The proposals that received the strongest support were as follows:

- Asset managers' financial performance should be judged over longer-term periods (at least three to four years, with high-water marks used to protect the investor from rewarding poor performance)
- These periods should be measured on a rolling basis, to avoid a 'cliff effect' when a manager reaches the end of a measurement period
- Beyond the technicalities of performance measurement, asset owners should be highly conscious of separating short-term noise from long-term performance information (see box 'Investment managers in the firing line' on following page)
- However, owners must not focus all their energies on measurement of their managers, even if those measurements are geared to the long term
 - ➔ Asset owners should spend more time on the initial evaluation of potential managers, including an assessment of the 'cultural fit' between the institution and their own investment beliefs
 - ➔ Many participants suggested that a better model may be to measure performance less frequently but in more depth (e.g. using attribution analysis), and to have more dialogue with the manager on the ongoing quality of the people and process. This process-focussed dialogue is likely to create trust and avoid nasty surprises for either party, and should take place regardless of whether the strategy is performing well or poorly
- New remuneration models could include a reduced annual management fee in exchange for a back load / leaving penalty², which would incentivise owners to remain with managers for longer time periods
 - ➔ Other means to encourage both the owner and the manager to commit to the investment strategy for the longer term could be lock-in periods (in line with the structures used in the hedge fund / private equity world) and longevity rebates on the management fee (a 'loyalty dividend')

² Payable to the manager or, in the case of a pooled investment vehicle, to the manager and remaining investors

- Asset owners should measure and perhaps insist upon meaningful levels of co-investment in the strategy by the asset management institution and its personnel
- Changes to traditional relationships should be adapted to the particularities of certain asset classes (e.g. liquidity constraints in infrastructure and private equity)
- It is critical that decision makers at the asset owners (e.g. the investment committee) demonstrate that they trust their asset managers once selected
 - ➔ Too often there is a blame culture or climate of fear at the managers, as if they were perpetually on a 'final warning'. This is highly damaging if the owner wants his managers to favour long-term over short-term outcomes
- Ultimately, successful long-term investment relationships rely on trust between the asset owner and the asset manager — not everything can be codified as written investment principles or regulated by the investment management agreement

According to Watson Wyatt there are four possible explanations for the bad performance of an investment manager:

- Poor skill: a manager has not been skilful, either because something has happened to affect their skill or the original assessment of that skill was incorrect
- Poor decisions: a manager has made some misjudgements. A few bad judgements should be expected and do not make a manager bad overall provided that there are good decisions also being made
- Poor luck: a manager has made some sensible decisions which proved unsuccessful due to events that could not have been anticipated
- Timing: a manager has a number of positions that have so far been unsuccessful, but there are reasonable hopes that they will turn around

"Looked at this way, the appropriate action falls naturally into place, which if poor skill applies the investment manager should be fired. In the three other cases, decisions are more difficult and call for keeping investment managers under more significant review while they regain investors' confidence."

Source: 'Investment managers in the firing line', Watson Wyatt, 2009

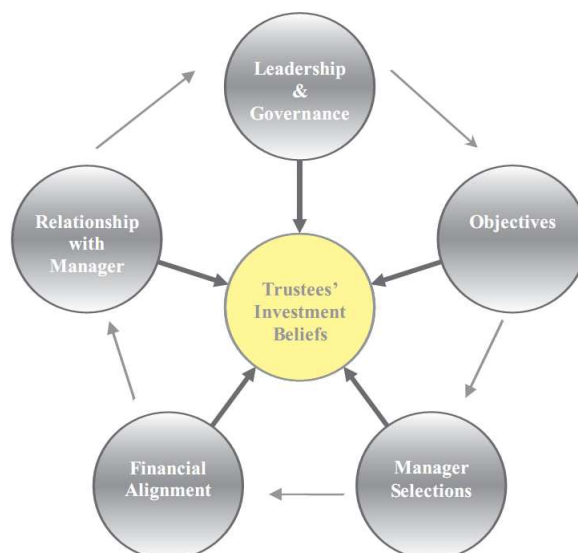
Workshop participants then went on to debate the positions taken by the Marathon Club³ on long-term investing. The Marathon Club's members are supportive of changes to the asset owner–manager relationship to better align manager behaviour with owners' long-term objectives. However, the Club has stated that:

- Although new measurement and remuneration models are important in terms of setting up a relationship that is likely to succeed in the long term, this is of secondary importance relative to the need for asset owners to invest much more time in the selection of their managers
 - ➔ The Marathon Club believes that asset owners often select managers too quickly and unsystematically. They should spend more time evaluating the quality of processes and people at the asset manager, and make their selection criteria more transparent to the market
- The Club believes that important criteria that are often overlooked in the manager selection process include:
 - ➔ The conviction, consistency and stability of the investment process. Does the owner believe that the manager can resist short-term performance pressures to deliver long-term objectives?
 - ➔ The culture of the institution or team that will be working on the strategy. Is there cohesion in the team, or a culture of competing 'stars'?

³ A UK-based coalition of approximately 20 asset owners. See <http://www.marathonclub.co.uk/>

- ➔ The level of co-investment by the institution and individuals
- ➔ The degree to which the manager is willing to accept a performance-based fee (important mostly as a minor disincentive for the manager to 'asset gather' rather than deliver performance for existing investors)

Components of long term mandate



Source: 'Guidance Note for Long-Term Investing', Marathon Club, 2007

Aligning incentives within asset managers

Addressing the final link in the chain, one of the asset manager participants (a boutique manager with an ESG focus) presented the characteristics of their organisation, which they believe support a long-term approach (see box below). The participant spoke not only of the direct benefits for the client in terms of alignment of interests, but also of the positive effect on the team culture that resulted from the measurement and remuneration systems.

Long-term alignment structures used by a boutique asset manager:

- The manager is employee-owned and 100% focussed on long-term, ESG-inclusive strategies
- Senior investment staff are meaningfully⁴ invested in the strategies alongside clients
- The management fee contains both asset-based and performance components, with the performance being assessed on three-year rolling periods
- Portfolio managers and analysts are likewise incentivised on a three-year rolling basis
- New clients are presented an investment in the strategies first and foremost as buying into a process and a team. Discussions of historical performance are secondary
- The ability of the manager to engage with investee companies on long-term strategic issues is enhanced by the alignment of all structures with a long-term investment outlook

⁴ As a percentage of their own private wealth

Strengthening the links with academia

A key component of the Mistra Sustainable Investments Platform workshops is the exchange of information and ideas between academics and investment practitioners.

During the workshop post-doctoral students from the University of Gothenburg's Department of Mathematics presented preliminary results of their work in this space. They are developing a model that attempts to calculate the likelihood of an asset manager delivering outperformance under various measurement and remuneration schemes. Participants gave feedback on the validity of the assumptions underlying the model and the most interesting parameters of the asset owner–manager relationship to test.

Research Hypotheses

Features that are assumed to affect long-termism are;

- Monitoring frequency.
- Having to beat a hi-water mark in order to get a bonus.
- Not being allowed to let the fund value go below some certain level.
- Having to beat a benchmark index.

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Source: Georgios Fofas and Mattias Sundén, University of Gothenburg

Appendices

About the host

Mistra

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Mistra, the Foundation for Strategic Environmental Research, aims to make a difference in the field of sustainable development. The Foundation achieves this by funding groups in the academic community that contribute to solving major environmental problems through applied research. Each year Mistra invests approximately SEK 200 million in the research programmes it supports.

The entirety of Mistra's endowment, which is currently valued at SEK 2.8 billion (USD 360m), is invested using external asset managers that explicitly take account of environmental, social and governance issues.

Event conceptualisation and facilitation

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Agenda

Date	Tuesday, 9 June 2009 (workshop followed by a networking lunch)
Venue	Mistra Gamla Brogatan 36–38, 111 20 Stockholm, Sweden

08:30 Coffee, registration

09:00 Welcome; framing the issues

- Eva Thörnelöf, [Mistra](#) and Gordon Hagart, [onValues](#)

09:15 Discussion 1: how asset owners make decisions

- Anders Biel, [University of Gothenburg](#): Changing asset owner beliefs — ESG as a case study
- Discussion to address:
 - ➔ Barriers to asset owners governing their activities for the long term
 - ➔ Possible solutions: individual actions, investor collaborations, regulatory intervention

09:45 Break-out session

- Two groups to work on:
 - ➔ Debating the hypotheses supplied in advance of the workshop
 - ➔ Sharing success stories where new approaches have been tried
 - ➔ Brainstorming alternative models for manager measurement and incentivisation

10:30 Coffee break

11:00 Discussion 2: building better investment relationships

- Roger Emerson, [Marathon Club](#): Mandates for the 21st century
- Georgios Foufas and Mattias Sundén, [University of Gothenburg](#): Optimising the way that asset managers are measured and incentivised
- Discussion to address:
 - ➔ The unintended consequences of traditional investment management agreements
 - ➔ The pros and cons of different measurement and payment models
 - ➔ Mistra to speak briefly on creating an empowering environment for asset managers

12:15 Closing discussion

- Ivo Knoepfel, [onValues](#)
 - ➔ Contributions from the academic community and next steps for owners and managers

12:30 Adjourn and networking lunch

Participants

Organisation	Name	Position	Country
AP2	Christina Olivecrona	Advisor Sustainability	Sweden
AP2	Carl Rosén	Head of Corporate Governance, AP2 and Chairman, AP1–AP4 Ethical Council	Sweden
Crédit Agricole Asset Management	Elisa Vergine	Analyst	France
Etablissement de retraite additionnelle de la fonction publique (ERAFFP)	Philippe Desfosses	CEO	France
Ethix SRI Advisors	Emma Ihre	Head of Corporate Engagement	Sweden
Generation Investment Management	Esther Gilmore	Relationship Manager	UK
GES Investment Services	Fredric Nyström	Key Account Manager	Sweden
Marathon Club	Roger Emerson	Chairman	UK
Mercer	Emma Hunt	Principal	UK
Mistra	Erik Sjöberg	Investment Consultant	Sweden
Mistra	Eva Thörnelöf	Deputy Managing Director	Sweden
onValues	Gordon Hagart	Senior Consultant	Switzerland
onValues	Ivo Knoepfel	Managing Director	Switzerland
Storebrand Investments	Jan Erik Saugestad	CIO	Norway
The Central Church Fund of Finland	Magdalena Lönnroth	Project Manager, Investment	Finland
Umeå University	Ian Hamilton	Researcher	Sweden
University of Gothenburg	Anders Biel	Professor, Department of Psychology	Sweden
University of Gothenburg	Georgios Foufas	Post-doctoral Researcher, Department of Mathematics	Sweden
University of Gothenburg	Tommy Gärling	Professor, Department of Psychology	Sweden
University of Gothenburg	Mattias Sundén	Post-doctoral Researcher, Department of Mathematics	Sweden
University of Oxford	Claire Woods	DPhil Candidate	UK
Watson Wyatt	Yodia Lo	Investment Consultant	UK

Hypotheses provided in advance to workshop participants

Hypothesis 1

The behaviour of pension funds in relation to issues such as long-term investing and the integration of ESG issues into investment is strongly influenced by the behaviour of peers, the opinions of consultants, and by regulatory frameworks.

Related reading: Perceived Influences on Adoption of Socially Responsible Investment Among Swedish Institutional Investors; Tommy Gärling, Magnus Jansson, Anders Biel, Maria Andersson (University of Gothenburg); December 2008

<http://gup.ub.gu.se/gup/record/index.xsql?pubid=84437>

From the paper: "The main impediment to SI practice may also be traced to incentives and rules that through imitation are adopted across organisations, potentially underlying the frequently-observed herding behaviour among institutional investors."

Hypothesis 2

When hiring and firing managers, fiduciaries' fear of being held accountable for mistakes leads them to over-emphasise past performance and to focus on short-term issues. Empirical studies show that their impatience can lead to value destruction. Pension funds should put a greater weight on qualitative research (quality of managers' investment approach, investment process and professional staff) when appointing managers, and not judge managers' quality on the basis of short-term investment outcomes.

Related reading: Defining moments, page 19; Watson Wyatt; July 2008

<http://www.watsonwyatt.com/research/resrender.asp?id=REM-EU-8020&page=1#>

From the paper: "Hiring and firing decisions are the responsibility of the fiduciaries and are consequently subject to their own constraint: fiduciaries will be concerned with whether others would judge their decisions to be prudent or not, which, to some extent, leads to an over-emphasis on past performance and 'brand' issues. In addition, an increasing appetite for alpha, a major trend identified by the Watson Wyatt/Financial Times expert opinion survey, typically overweights past performance and results in more impatient decisions."

Hypothesis 3

Co-investment, closed-end investments and new fee structures are crucial in aligning both asset owners and asset managers to successful long-term investing. Fees could for example be structured as a low base fee plus a performance fee calculated over a rolling period of several years.

Related reading: Seeking Alignment with Managers; Marathon Club / Yusuf Samad; January 2009

<http://www.marathonclub.co.uk/Docs/ActiveEquityandBondManagement.doc>

From the paper: "There is a concern that performance fees could encourage more risk taking. This can be controlled through specifying investment guidelines or high water marks. Another important feature to align long-term incentives is to pay the performance fee over rolling periods, e.g. three years. There is another myth that performance fee structure produce better returns. Most managers will frankly admit

that the fee structure makes no difference to the way they manage money. This is probably true but the advantage of a performance structure is that it discourages asset gathering."

Hypothesis 4

Pension funds need to be more explicit in declaring to what extent long-term goals are part of their investment beliefs, objectives and manager selection criteria. Asset managers will expect to see those beliefs reflected in the way mandates are formulated.

Related reading: Guidance Note for Long-Term Investing, pages 10–11, 14–15, Appendices A, B; Marathon Club; April 2007

<http://www.marathonclub.co.uk/Docs/MarathonClubFINALDOC.pdf>

From the paper: "The Marathon Club considers that the formulation and articulation of trustee investment beliefs is a fundamental building block in the setting of a coherent investment policy. Putting these beliefs in writing establishes a reference that will help trustees in withstanding the uncertainties and challenges created by market movements. Consultants and managers are more likely to respond in the right way to what the trustees require if those beliefs are expressed clearly. We suspect that many trustees may not have articulated their beliefs with sufficient clarity."

Hypothesis 5

Long-term investing is not possible in the absence of a reasonable level of mutual trust between asset owners and their managers, as not everything can be codified in writing. If the trust is not in place, managers will gravitate towards short-termism and decisions that can be most easily defended if they are wrong. The current financial crisis has eroded trust levels on both sides and made long-term investment even more challenging.

Related reading: The Ambachtsheer Letter 236: 'Beauty Contest' Investing — Not Dead Yet; KPA Advisory Services; September 2005

http://www.kpa-advisory.com/pdf_documents/236.pdf

From the paper: [Commenting on Danyelle Guyatt's PhD research, which quotes institutional asset managers as follows] "If the trust is not in place, you have to make decisions looking over your shoulder. You gravitate towards those decisions which can be most easily defended if you are wrong." "I think any fund manager will tend to focus more on short-term goals because you have to be very brave to take a long-term, say a five-year view, because if you get it wrong for the first three years, the chances are that you're going to get fired before the five-year period is up!"