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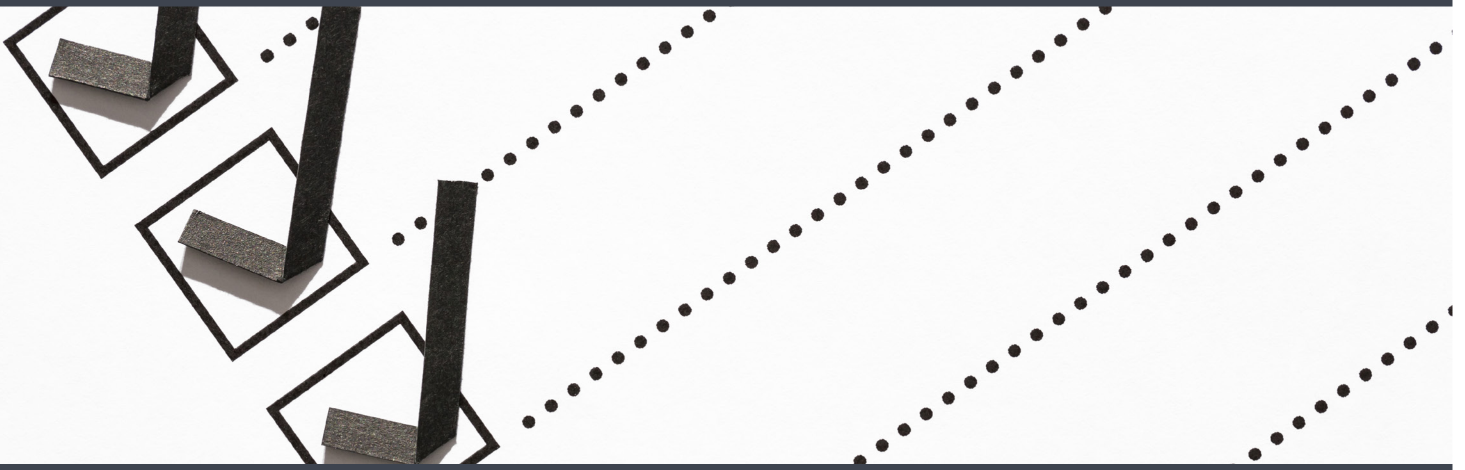

Ten Ideas to Foster Long-Term Investing

Final Paper in the Brandes Institute's "Long-Term Investing Trilogy"

by David Iverson and Geoff Warren[1]

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> "…successful long-term investing requires a long-term mindset to be deeply embedded within an organization."

Overview

Brandes Institute Advisory Board members Geoff Warren and David Iverson previously published two research papers on principles related to the topics of long-term investing ("What Does It Mean to Be a Long-Term Investor?") and organizational design ("Organizational Design and Long-Term Investing"). In this piece, the authors distill their work into ten suggestions that build on their previously published work and offer practical action items designed to build and maintain a long-term mindset within an organization.

This is the final paper in a trilogy on long-term investing, written with investment organizations in mind. The first paper (Warren, 2016) considers what it means to be a long-term investor. It argues that long-term investors may be characterized by their *latitude* and their *intent* to pursue long-term goals. Ideally this should be supported by a capacity for patience, discretion over when to trade, and objectives and investment processes that are squarely focused on long-term outcomes. The second paper (Iverson and Warren, 2018) addresses aspects of organizational structure that can support the pursuit of long-term investment opportunities. It discusses four success drivers: investment beliefs; governance; aligned interests; and people. Central to both papers is the concept that successful long-term investing requires a long-term mindset to be deeply embedded within an organization. Such a culture can support an unwavering focus on long-term objectives and a capacity for patience while providing resistance to short-term performance pressures.

The first two papers in the trilogy are primarily concerned with setting out concepts and principles. This third and final paper takes a different tack. The aim here is to come up with the "best ideas" for entrenching a long-term mindset within an investment organization. The approach is to set out the broad aim, then offer practical action items. We have arrived at the ten ideas after consultation with other members of the Brandes Institute Advisory Board. Ideas were filtered by consideration of "bang-for-buck" and how practical they are to implement. The ideas are arranged under the four success drivers discussed by Iverson and Warren (2018).

Investment Beliefs

1. Ensure that principles are unambiguous about investment horizon

An organization's guiding principles—its mission, objectives, investment beliefs and investment processes—provide both the glue that binds and the compass that directs everybody along the same path. Focus can be disrupted by guiding principles that are ambiguous. If the intent is to invest for the long term, then the guiding principles should be unambiguous about investment horizon. Any principles that create horizon confusion should be jettisoned, such as those alluding to short term relative performance. For instance, a pension fund should avoid dual objectives like delivering long-term real returns *and* outperforming peers over (say) rolling 1- to 3-year periods. The aim is to ensure that sights remain set solely on working toward long-term outcomes. Exactly how the long term is defined is secondary to the perspective and mindset that is engendered. Nevertheless, any definition should probably encourage looking beyond just one investment cycle, which implies that 5-years or fewer is probably too short. Ten years or more is getting into the range.

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Action items:

- Jettison any shorter-horizon references contained with the stated mission, investment policy statement or documentation of investment process.
- Ensure the words "long term" or equivalent are prominent and defined in a way that set sights beyond the current investment cycle.
- Focus performance reports and reviews of investment activities on long time frames.

2. Stick to your knitting

There is no "one size fits all" prescription for investment strategies and organizational structure for acting as a long-term investor. Each organization has its own objectives, beliefs, governance, capabilities and resources. As a result, each investment organization will have investment strategies that play to its strengths in generating long-term results. Not every organization will be good at everything, nor can it be. Long-term strategies suitable for one investor may not suit another.

Action items:

- Link long-term investment strategies to beliefs, resources and capabilities.
- Stick to those long-term investment strategies.
- Remain disciplined and avoid chasing investment fads and the "new thing."

Governance

3. Slow down the decision cycle

A long-term investor probably has more to gain than lose by slowing down the information flow and decision cycle.

It is often thought that information flow and related portfolio needs should be constantly monitored so as not to miss any opportunities and ensure best-positioning. Investment organizations may set themselves up accordingly, with morning meetings, daily performance attributions, and so on. Is this really helpful if the objective is long term in nature? The constant flow of stimulus merely invites action and can divert attention away from matters that are slow-moving but important. Further, the best long-term opportunities typically evolve over time, rather than arriving with a bang for a fleeting moment. The Global Financial Crisis (GFC) was the last major market dislocation that (with hindsight) provided significant opportunities for long-term investors, and the optimal entry point was about six months after Lehman collapsed. Markets have often run further and longer than most expected: the mistake may be to act too soon. A long-term investor probably has more to gain than lose by slowing down the information flow and decision cycle.

Action items:

- Report less often: why not quarterly, at most? Junk the daily or weekly attribution analysis.
- Hold fewer regular meetings and make them more meaningful. Junk the daily morning meeting.
- Spread out the decision points, e.g. impose a quarterly cycle, rather than continuous review. Removing the ability to act quickly may actually aid contrarian or value-based investing.
- Always have "do nothing" or "wait" on the table as options—perhaps even as the default.

The centerpiece of performance reporting and commentary should be measures that focus on progress toward objectives.

4. Reframe around progress toward objectives

Framing can have powerful effects on how people react to information. When it comes to investing for a long-term objective, it may help to frame performance around progress toward that objective rather than historical performance. This places the long-term objective at the center of performance measurement and encourages looking forward rather than backward. Some of the ideas appearing under the action items below are illustrated in the break-out box.

Action items:

- The centerpiece of performance reporting and commentary should be measures that focus on progress toward objectives. Relegate quarterly, 1-year and 3-year historical performance to something similar to a passing footnote.
- Where the objective involves a wealth target, plot the path of wealth toward the target.
- Where the concern is income (e.g. retirement savings), convert balances into potential income.
- At the very least, report returns as rolling performance over long periods such as 10 years, thus emphasizing the evolutionary nature of investing for the long term instead of year-by-year results.
- When investing to capture long-term fundamental value, consider attributing returns into changes in fundamentals and repricing effects. Then focus on whether the fundamentals remain intact. For a method to attribute returns into cash flow and discount rate effects, see Warren (2016).

Framing Changes Perspective

The set of charts below illustrates how framing can alter perspective, perhaps dramatically. The four charts are different presentations of hypothetical returns from the Datastream World Equity Index in US$. The first chart (upper left) plots the hypothetical yearly return from a portfolio mirroring the Datastream World Equity Index versus a notional Consumer Price Index (CPI) +4% return target: a picture of short-term returns. Here the tech wreck of 2000 and the Global Financial Crisis (GFC) of 2007-2008 stand out as periods of notable loss. The second chart (upper right) is the same data presented in its 10-year rolling form. While the line still dips during the tech wreck and GFC, the decline is not as dramatic and the return series remains positive. The worst result appears in 2008-2009, which spans both episodes. A long-term investor should be more concerned with the possibility of 10 years of sub-par returns. The third chart (lower left) shows the performance of a hypothetical $100,000 investment in a portfolio mirroring the Datastream World Equity Index in 1990 versus a notional $750,000 target looking toward retirement in 2025. (We have ignored contributions to keep it simple.) The tech wreck and GFC now appear as blips along a satisfying trajectory toward an objective already achieved. The fourth chart (lower right) shows one example of the potential annuity income that could be obtained by selling the securities in the portfolio in a given year and using the proceeds to purchase a 30-year immediate, fixed-term, without life contingency annuity (calculated with reference to 30-year US Treasury yields), which is then adjusted for inflation so that the series is plotted in 2017 dollars. (We multiplied the portfolio value, based on the index returns, by the annuity function in Excel using the 30-year Treasury yield as the equivalent income stream.) It reveals how implied income-purchasing capacity compares with a notional target of $50,000 in income during retirement. The contrast in the portfolio balance in the third chart being above-target and the annuity income being below-target is substantially due to the decline in bond yields making annuities more expensive. Here the dips in the tech wreck and the GFC are of more concern, as they wipe out much of the previous progress toward the target. Importantly, this chart might spur a conversation that does not

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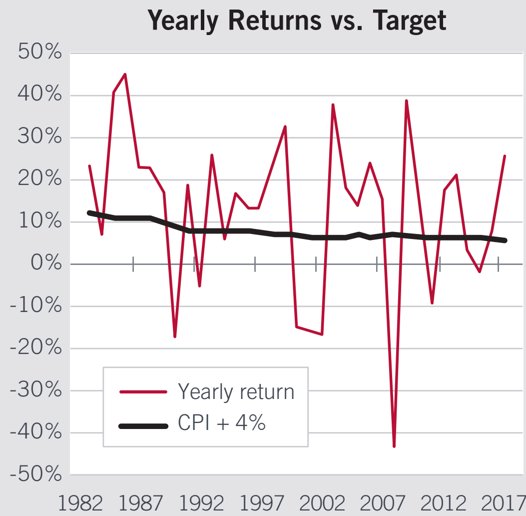
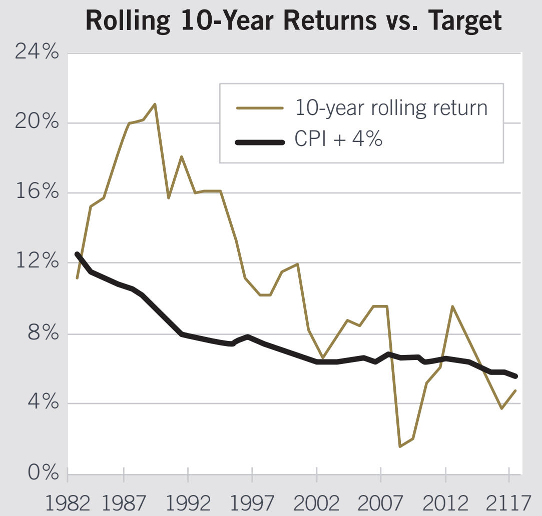
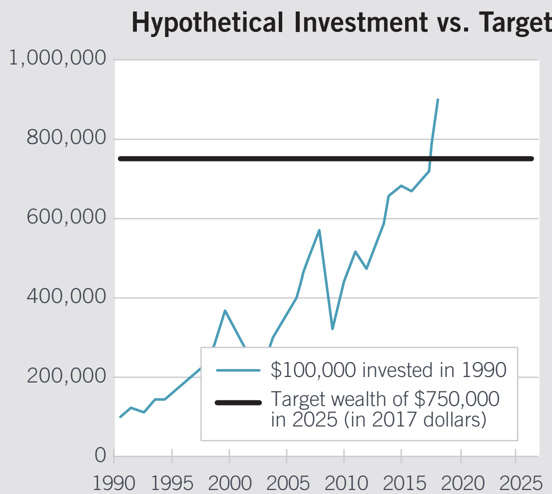
lead to the question of whether equities are too risky and should be sold. It invites discussion over whether additional contributions may be required, or if income expectations should be lowered. In any event, the differing presentations will invoke differing responses.



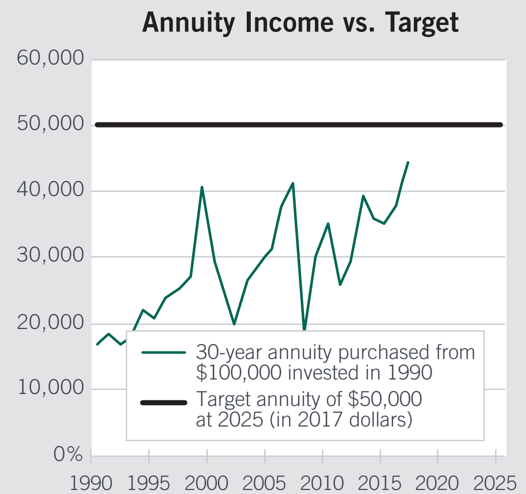
Source: Datastream World Equity Index, 1983 to 2017



Source: Datastream World Equity Index, 1983 to 2017



Source: Datastream World Equity Index, from 1990 to 2017 and estimated toward 2025



Source: Datastream World Equity Index, from 1990 to 2017 and estimated toward 2025

All illustrations are hypothetical. Does not represent the performance of any specific investment. Your actual results may vary. No investment strategy can assure a profit or protect against loss. One cannot invest directly in an index. Rolling periods represent a series of overlapping, smaller time periods within a single, longer-term time period. For example, over a 20-year period, there is one 20-year rolling period, eleven 10-year rolling periods, sixteen 5-year rolling periods, and so forth. Past performance is not a guarantee of future results.

Aligned Interests

5. Touch, pause, engage

For those confused about this term, it is a direction from rugby referees to set and control scrum engagement. Similarly, close and purposeful engagement between principals and agents all along the delegation chain within any investment organization is important for fostering long-term investing. We specifically refer to engagement over investment decisions and how they relate to investment

outcomes. Such engagement should occur between the fund and its beneficiaries; the governing board and fund executives; fund executives and investment staff; and investment staff and external managers. The aim is to build both trust and mutual understanding of decisions. In this way, principals should become less influenced by the flow of performance numbers in evaluating the agent and more concerned with whether the agent is diligently pursuing long-term objectives in an appropriate manner. The major benefits of engagement will emerge during those inevitable times when performance is poor and relates to both the capacity to stay the course and sending the right messages. If the principal understands why decisions have been made and has faith that they are directed toward long-term objectives, it becomes less likely that they will pull the plug and send a message that they are focused on short-term performance.

Action items:

To a large part, this idea relates to how agents communicate with principals during forums such as formal meetings, reports and even casual discussions. Explicit attempts should be made to include the following in these communications:

Review outcomes in terms of how they link to the pursuit of long-term objectives.

- Explanations of investment processes and decisions and how they link to long-term objectives. Transparency should be considered as more important than protecting intellectual capital.
- Set expectations about timing, i.e. prepare the principal for the possibility that pay-offs may take time.
- Review outcomes in terms of how they link to the pursuit of long-term objectives. Did we act as previously explained? Is the long-term investment thesis still valid or do we need to change course? What have we learned?

6. Reward behavior, not just performance

A long-term organization should encourage behaviors that are consistent with the pursuit of its long-term mission. Why not observe and reward behavior directly, rather than rely solely on performance as a measure of contribution? Doing so helps overcome one of the big challenges of long-term investing: that investment performance may not flow immediately from actions taken. In particular, there will always be uncertainty over whether any short-term underperformance indicates poor skill or merely a delay in the payoff. And it is often impractical to wait for an outcome—which could take years—to judge whether a contribution has been made. (For a discussion of this issue, see Neal and Warren, 2015.) Focusing on behaviors rather than investment performance alone offers a way around this conundrum.

Include a subjective component in incentive remuneration for management and staff.

Action items:

- Include a subjective component in incentive remuneration for management and staff. Explicitly use it to acknowledge behaviors consistent with pursuit of the long-term mission, such as investing in accord with long-term investment beliefs and processes, building valuable relationships, contributing to the team, enhancing the organization's reputation, and so on.
- Apply a similar philosophy in evaluating external managers. Performance fees plus a discretionary component might even be considered under segregated mandates (if practical).

A long-term investment organization might set up some formal processes and guidelines to ensure that only information with long-term relevance is considered.

7. Police the information perimeter

A long-term investment organization might set up some formal processes and guidelines to ensure that only information with long-term relevance is considered. The information that is collected helps dictate what is deemed as important and can drive decisions accordingly. Further, what is considered "information" needs to be defined in light of objectives. Under long-term investing, this will often be information that provides insight into long-term fundamentals and long-term returns. Within an equity investing context, this may include developments shedding light on long-term cash flow generation, investment opportunities, rates of return, deployment of capital, reliability of management, and so on, all compared to the price paid. Matters that are irrelevant include who is buying or selling, what peers are doing, market flow information, how the next company result might differ from consensus, rumors, and so on.

Action items:

- Define what information is admissible, perhaps within the investment policy statement.
- Appoint an information "perimeter cop." The role of this person would be to blow the whistle when the team starts paying attention to the "wrong" types of information.

We think a much better strategy is to award incentives based on yearly performance, but then make vesting conditional on that performance being sustained over the long term.

8. Make incentives conditional on sustained performance

The industry standard is to award incentives on a yearly cycle based on performance, whether for investment staff or fund performance fees (although the basis of calculations may vary). The inconsistency between yearly awards and investing for the long term has attracted much discussion. One reaction has been to suggest awarding incentives for historical outperformance over long periods, say over five years or even more. However, this can be problematic. It assumes the beneficiary of the award has continuity in his or her role. If performance falls too far behind, it can create perverse incentives to either enter a crapshoot or leave and try elsewhere. We think a much better strategy is to award incentives based on yearly performance, but then make vesting conditional on that performance being sustained over the long term. For instance, if a manager beats its benchmark or other objective over the year, an incentive payment is placed into a tin. However, the manager can only take the incentive payment out of the tin after an extended period of (say) five years or more if the performance contribution is not given back.

While there is no perfect system of incentive payments, this approach offers certain advantages. It accommodates the industry norm of awarding yearly incentives, but only rewards long-term performance. However, unlike a system based on trailing long-term returns, the history in place at the start of each year does not preclude earning a bonus going forward (although it can wipe out accrued incentives not yet vested). This removes some of the perverse incentives mentioned above. Further, vesting encourages the manager to remain with the organization, which helps cement commitment and provides additional incentive to adopt a long-term view. The arrangement may also extend into post-employment, which will engender concern with leaving behind a solid legacy and portfolio. There are some problems, such as the manager remaining exposed to a portfolio that it does not control after individuals have left. The option-like nature of the payoffs may also create incentives to de-risk after a big win in order to secure the bonus. Nevertheless, yearly awards with conditional long-term vesting seems a good solution on balance. Warren (2014) further discusses the idea, and provides some references.

Action item:

- Convert yearly incentive awards for investment performance into a conditional payment that vests only if performance is sustained over a long period of five years or more.

People

9. Employ patient, farsighted people … and offer them long careers with purpose

"People" is one of the four key success drivers discussed by Iverson and Warren (2018), who make the seemingly trite but substantial point that organizations consist of people, and people make the investment decisions. The initial aim is to only employ people with a predilection toward the long term, leaving staff diversity to operate along other dimensions. A capacity for patience and farsightedness should be a non-negotiable selection criterion. The next aim is to encourage staff to operate with the *intent* of remaining with the organization and with commitment to its long-term mission. One way to do this is to offer long and rewarding careers pursuing a purpose in which they can believe.

Action items:

- Include "affinity for long-term investing" in the employee selection criteria. Set out to probe this attribute during the interview process or perhaps via personality testing.
- Invest in people, e.g. provide training and mentoring.
- Promote internally where possible.
- Build a culture that entails a sense of mission importance and mutual respect.
- Expect staff to live up to the organization's guiding principles. Include this in job descriptions. Terminate for failure to meet this expectation and not because of poor short-term investment performance.

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10. Manage the behavioral flaws

Behavioral flaws or biases can play a role in shortening investing horizons. Some of the more important biases for deterring long-term investing are discussed in Iverson and Warren (2018). In general, behavioral biases can distract from the long-term mission through: heightened concern with short-term outcomes and short-term loss; overweighting of information that is more recent and readily available; creating propensity toward action and overreaction; herding; and groupthink. The aim is to build awareness within the organization of the existence of behavioral flaws and how they can manifest in investment decision-making and then manage them accordingly. To some extent, adherence with the concepts outlined elsewhere within this paper should also assist by creating an environment where there is less scope for behavioral flaws to dominate. The following items might enhance the organizational resistance to biases.

Action items:

- Assign specific responsibility to someone in the organization to monitor and highlight any behavioral issues that may be inhibiting the sound practice of long-term investment. This role might be assigned to the Chief Risk Officer, for instance.
- Management should expect adherence to organization principles and processes and ask for any deviations to be explained. The objective is to ensure decisions are made in accordance with established protocols and inhibit scope for discretionary actions that may invite behavioral biases.

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Disclosures

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