An Unshakable Belief in The Long Term

Safeguarding capital for the future generations of a nation should be easy, but our natural human frailties make it hard. Success requires good governance, a principled view of global markets, and the courage to stick with those principles through good times and bad.

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The general nature of the problems that bedevil the long-term investor are explained well and in substantial detail elsewhere. I offer a perspective from the Guardians of New Zealand Superannuation, a New Zealand government entity established to prefund future pension liabilities, on some of these issues in this article. I focus on the view that good governance is the indispensable prerequisite for successful long-term investment.

Earlier this year, I had the privilege of speaking with several Pacific Island University students in New Zealand about their opportunities. For whatever insight I may have provided, I was thoughtfully and generously thanked with some of Auckland's finest baking. Under usual circumstance, gifts received by the Guardians are auctioned to staff at the end of the year, with proceeds going to charity. The cupcakes, however, by virtue of being perishable and valued at under $50 (though I thought them priceless), made their way home that evening, to the appreciation of both my family and Bud, the dog.

Like all gifts and hospitality received by fund staff, the baking was duly entered into a register that was published at the end of the financial year together with the detailed and complete records of our portfolio strategies, investment managers and holdings, performance, compensation, expenses, and other miscellany.

We take full transparency as the default starting point at the Guardians. It forms a bedrock element of governance arrangements that cascade all the way from our founding legislation to the policies that set out delegated authorities, asset allocation, and enterprise risk management. It also infuses a commitment to a culture defined by constructive achievement. Our transparency is intended to mitigate the agency problems that inevitably arise in the management of other peoples' money—problems that are more difficult to resolve the longer the investment horizon.

THE GUARDIANS AS A LONG-TERM INVESTOR

The "long term" means different things to different people, and we have found it essential to sieve through theory and practice to establish consistent thinking on this in the context of our goals, endowments, beliefs, and capabilities. Our deliberations have yielded a distilled view on what it means to be a long-term investor. More importantly, we have asked ourselves if we have the capacity and judgment to take the long view in our own investments and reap the advantages that are available to such an investor.[1] For us, the most useful definition is that a long-term investor is one who can hold any investment strategy for as long as the investor wishes. Therefore, investing for the long term is largely concerned with the ability to control the deployment of risk capital at all times, and especially at times of market

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dislocation and turmoil. In other words, the long-term investor must have the resources and discipline to resist short-term forces that could cause a deviation from the overarching strategy.

This discipline must be institutionalized. The Guardians are only able to maintain this control because certain institutional characteristics are to the fore: a government and beneficiary that has granted a commercially focused mandate to a board that then independently decides on a desired risk-return profile and investment strategy for the fund; the board's support of management in the execution of the strategy; limited claims on capital; sufficient liquidity; and generally low levels of peer and agency risk.

Before I turn to the links between these characteristics and our governance arrangements, it is useful to summarize the advantages we see in long-term investing. Each is conditional on a particular belief about the nature of financial markets and that of other participants.

One of our investment beliefs is that financial markets are not perfect—short-term behavior is both cause and consequence—implying that there are substantial periods of time when asset prices become unanchored from their fundamental values and that prices do, eventually, return to these values. If the views on the core investment risks that we are willing to adopt do not change with prices or other market developments, then it makes sense for the fund to invest against the market. We look to buy when others panic and sell, and we look to sell when others are euphoric and eager to purchase. Our view allows us to be more levelheaded, to discount short-term manias and panics in equal measure, and to seek long-term profit from these instead.

One consequence of panics and crashes is that when they occur, the market balance between demand and supply tilts overwhelmingly in favor of supply, with most either looking to sell or, as is more likely, being forced to sell to meet their other financial obligations. In anticipation of these times, assets considered easier to sell quickly as the need arises trade at a premium to illiquid assets. A long-term investor who generally does not have other financial obligations that force him or her into selling can benefit from acquiring the illiquid assets that are cheaper because they are less attractive to the general (short-term) investor. Given that a long-term investor can invest in anything that a short-term investor can but is also more likely to consider illiquid assets, they benefit from increased choice and better diversification.[2]

The investment markets are characterized by relationships that are distanced and transient. If, instead, we can forge strong relationships with the companies we invest with where all partners are aligned on generating long-term value, then, again, a potentially wider investment universe opens up to the fund. This is an advantage as long as our belief holds that these long-term relationships have the capacity to enhance risk-adjusted returns. Incidentally, secure long-term holdings are also advantageous for the companies we invest in. For example, the natural life cycle of assets such as forests, infrastructure, and unlisted companies gears them toward returns in the long term. Such opportunities may struggle to attract competitive capital from investors with shorter-term investment horizons, making it less likely they will be funded. More generally, confident in the knowledge that their investors are not flighty, investee companies are freed from the requirement to focus on short-term earnings and profits and can instead set sights on defining and executing strategies for the long term.

Finally, at the fund, we characterize investment themes as the long-term secular influences on the global economy that are inexorable and invariant to business cycles. For example, the aging of populations, the warming of our climate, and the urbanization of developing countries are themes that will play out over several generations irrespective of the periodic booms and busts of the global economy. As long-term investors, we are ideally suited to examining the implications and positioning ourselves to invest in opportunities that will only yield returns as the themes mature.[3]

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THE ROLE OF GOVERNANCE

Our pursuit of these advantages requires that we identify the right investment strategies and then demonstrate the wherewithal to persist with them during market rallies and declines. Steady hands are of course important during the good times: discipline must be maintained in rebalancing portfolios, in selling when prices exceed valuations, and in resisting competing for overpriced assets. However, it is in the bad times that our mettle as a long-term investor is truly tested. Happily, this is also when the available advantages and a long-term investor's endowments can be fully harvested. Maintaining focus is difficult, and it is human nature to flee to safer shores (and thus dampen career risks). Good governance arrangements, agreed to in advance and relatively immutable, combat these tendencies.

The Guardians use to the fullest extent our enabling legislation, which provides operational independence and a wide investment spectrum. This provides us the confidence to enter into investment arrangements that best suit the fund's long-term purpose, with minimal agency risks that our owner (the government of New Zealand) will suddenly change our mandate. Our sovereign status is also beneficial in bringing the potential for us to be regarded favorably as stable sources of capital by business partners at home and abroad.

In the absence of sufficient information about the nature of the financial markets, there is substantial room to be swayed by fads and ideas that promise superior returns. Consequently, it is essential to distinguish between these and genuine investment insight, and this begins by articulating a well-founded investment philosophy, or set of investment beliefs. These beliefs are framed not just by an investor's understanding of market characteristics but also by the introspection required to identify their own strengths and weaknesses. As my colleague David Iverson writes in *Strategic Risk Management: A Practical Guide to Portfolio Risk Management* (Wiley, November 2013), "Investors without strong investment beliefs tend to drift from one strategy to the next. . . . Investors with clear investment beliefs tend to be more consistent and disciplined in their investment strategies and are more likely to achieve their investment objectives."

The Guardians have put in substantial effort at identifying our core investment beliefs, and our investment-decision process is fundamentally linked to these. The shared beliefs give us the confidence to choose specific investment strategies. The anchoring of our investment strategies to our endowments and beliefs enables us to stay true to our stated investment course, often when it feels the most unnatural. For example, it was exactly this anchoring that allowed us to negotiate the depths of the global financial crisis with a sense of opportunity rather than dread by retaining the focus on the important questions: Have our beliefs changed? Are our strategies correct? Do we have the capability to manage day-to-day financial operations in an unprecedented credit environment?

Our endowments and our long-term investment strategies that rest on clearly articulated beliefs can be made irrelevant if either the investment process or execution that follows is shoddy. How do we ensure consistency and discipline in our investment decisions, and how do we justify our choices? How do we balance the desired continuity and institutional perspective with dynamic, clever people?

Transparency is fundamental to the Guardians of New Zealand Superannuation; even the cupcakes must be accounted for.

In resolving these questions, we have decided on a benchmark investment strategy founded on a low-cost, passive, readily implementable global portfolio expected to achieve the fund's objective. This reference portfolio is chosen by the board and embodies its view of the risks that are appropriate for the Guardians as a long-term investor. For whatever other investment strategies we may choose, the reference portfolio allows all to gauge whether our activities add value. Separately, the single reference-portfolio construct also supports our cultural ambitions of working together as one team pursuing our collective goal.

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For the active investment decisions we make, we have established a risk-allocation process that allows us to rank opportunities by financial attractiveness (expected returns adjusted for risk and our confidence) and consistency with our endowments, beliefs, target operating capabilities, and responsible-investment commitments. In short, we periodically identify and quantify the sources of risk and return in all active opportunities, including those already mandated using consistent methods and inputs. This allows us to clearly understand the additional risks each investment brings to our benchmark-reference portfolio, the return we expect to compensate for those risks, and the initial signal to allocate capital to and from investments on a timely, consistent, and commercial basis.

Finally, I note another element of our governance framework, sometimes overlooked by others, that relates to responsible investment. We believe that responsible investors must have concern for environmental, social, and governance factors because they are material to long-term returns. Our view is that constructive engagement is both good for returns and the advancement of our objective to be active owners and responsible investors. We also acknowledge the wider beneficial impact on corporate practice, regulatory standards, and the general functioning of capital markets from active, constructive engagement.

Good investments will come and go, and views on good investment strategies will change only slightly less often. However, it is a good governance framework that will primarily give the Guardians the discipline, courage, and consistency to stay the course and achieve our mission of reducing the tax burdens on future New Zealanders. Having been granted a "license to operate" on the basis of this framework, we owe it to our sponsors and all New Zealanders to be transparent and accountable for the choices we make—right down to cupcakes taken home. ■

[1] My comments in this section summarize the more detailed views in Sue Brake and Rishab Sethi, "The advantages of being a long-term investor," Guardians of New Zealand Superannuation "How We Invest" white paper, September 2014, nzsuperfund.co.nz.
[2] Of course, increased choice is only beneficial when these choices can help improve portfolio risk-adjusted returns. See Joe Cheung, "Diversification," Guardians of New Zealand Superannuation "How We Invest" white paper, September 2014, nzsuperfund.co.nz.
[3] These benefits are conditional on a degree of mispricing in the opportunities and the evidence for this is more uncertain than for the other advantages described.