

Taking the long view

**A toolkit for long-term,
sustainable investment
mandates**



**UNIVERSITY OF
CAMBRIDGE**

INSTITUTE FOR
SUSTAINABILITY LEADERSHIP

Investment Leaders Group

The Investment Leaders Group (ILG) is a global network of pension funds, insurers and asset managers committed to advancing the practice of responsible investment. It is a voluntary initiative, driven by its members, facilitated by the Cambridge Institute for Sustainability Leadership (CISL), and supported by academics in the University of Cambridge.

The ILG's mission is to help shift the investment chain towards responsible, long-term value creation, such that economic, social and environmental sustainability are delivered as an outcome of the investment management process as investors go about generating robust, long-term returns.

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Rewiring the Economy is CISL's ten-year plan to lay the foundations for a sustainable economy. The plan is built on ten interdependent tasks, delivered by government, finance and business co-operatively over the next decade to create an economy that encourages sustainable business practices and delivers positive outcomes for people and societies.

Publication details

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Foreword

Mark Lazberger

CEO, First State Investments

Since John Kay published his internationally acclaimed report on the UK equity markets and long-term decision making in 2012, the debate as to the merits of long termism and the pitfalls of short termism have continued to exercise the minds of policy makers, regulators, industry commentators and investment professionals alike from all around the world.

From this debate there has emerged a general consensus that short termism in the world's capital markets has not served the end saver well and has encouraged behaviours which undermine the principles of good stewardship from both investors and corporate executives.

What has not yet emerged from this debate is a consensus as to how, in practice, a relationship between client and manager can be constructed, implemented and monitored for a long term, long only active equity investment mandate. Neither have any meaningful steps been taken to develop the measurement tools and reporting frameworks which can reflect and allow appropriate oversight of the performance of such approaches.

This "how" question was one which the Investment Leaders Group (ILG) sought to address through this work stream. This report, developed with input from both ILG members and other market participants from around the world, aims to help answer that question by providing guidance on processes, practices and implementation which can, in part or on the whole, be adopted to align with an investor's specific culture, philosophy and investment approach.

We were delighted to work with our ILG colleagues in leading this specific work stream as we believe that it is an important and welcome contribution to emerging best practice for investment which encourages rather than undermines, the adoption of sustainable business practices by companies.



Investment Leaders Group (ILG) members 2016



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This report is part of a series of related outputs on responsible investment published by the ILG and CISL:



The moral, financial and economic justification for responsible investment, and the academic evidence underpinning future action.



Analysis of the short-term risks stemming from how investors react to climate-related information.



Guidance on the characteristics of mandates that encourage long-term, sustainable investment management.



Assessment of the impact of carbon-related regulation on asset profitability.



A framework to help investors measure and communicate their contribution to sustainable development.

Executive summary

This report provides a toolkit for investors who wish to design investment strategies that can make a particularly strong contribution to long-term, responsible and sustainable investment, or to assess the extent to which existing strategies contribute to it.

Short-termism in financial markets has been widely identified as a cause of underinvestment, economic inefficiency and poor decision-making by corporations that undermines long-term value creation. Investor short-termism is also regularly cited as a barrier to companies making more progress towards sustainable business practices.

Given the ILG's focus not just on financial returns but also on encouraging sustainable business practice by investee companies, we focus here on active fundamental equity investment (investment in listed companies based on thorough research into their business prospects). Listed equity represents a substantial proportion of the risk in many asset owners' portfolios, and a large proportion of total assets for many. It is an important asset class for many investment managers. Listed equity is a growth asset, where fundamental analysis focuses on both upside opportunities and downside risk – unlike fixed income, where the focus is only on the downside. Stewardship concepts and activity are well developed in listed equity. Fundamental active equity therefore offers significant opportunities to influence company practice through the way asset managers conduct research to support investment decisions; allocate capital; and conduct stewardship.¹

The ILG defines 'long-term, responsible and sustainable investment' (LTRSI) as 'investment that promotes increased long-term value creation by companies and in the economy as a whole, and more sustainable business practices by companies. Investment of this kind is characterised by a clear and disciplined investment philosophy, process and culture, rather than a rigid set of rules or criteria. It focuses principally on long-term factors that determine companies' earnings, rather than short-term factors that may predominate in determining share prices. Its time horizon is likely to be five years or more. Committed stewardship is an integral part of long-term, responsible and sustainable investment.'

This toolkit illustrates how various design features of an investment strategy and for actively managed listed equities mandate can be adjusted to deliver varying 'strengths' of LTRSI to suit an asset owner's particular circumstances.

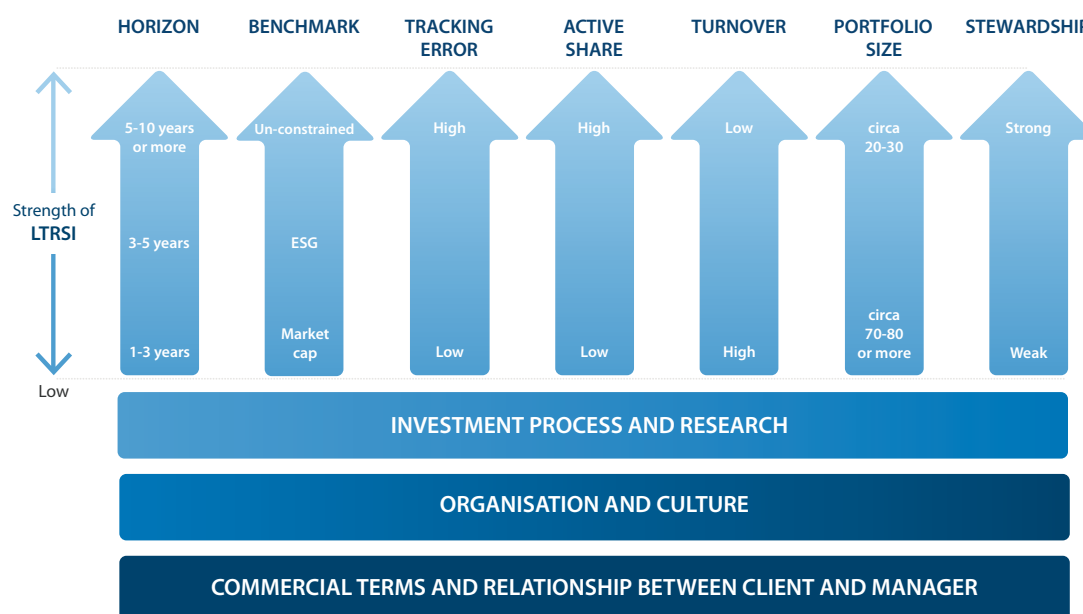
The toolkit addresses:

- investment beliefs
- the use of benchmarks
- risk, tracking error and active share
- turnover and holding periods
- portfolio size
- stewardship
- investment process and organisational culture
- performance monitoring and reporting
- the commercial model and fund manager incentives
- the relationship between the asset owner and the investment manager

This report was developed through desk research, discussion among ILG members and a consultation with asset owners and other investors worldwide. The ILG wishes to thank those who took part in the consultation; their names can be found in Annex 3.

Executive summary *continued*

Building blocks of long-term, responsible and sustainable investment



The key points highlighted in each of these areas are set out below.

Investment beliefs

- Asset owners should set out their investment beliefs on long-term investment and sustainability, eg how these relate to performance and risk.
- Successful implementation of LTRSI will be supported by beliefs that long-termism is conducive to value creation by companies and in the wider economy; environmental, social and governance (ESG) issues are sources of long-term (as well as shorter term) risk and opportunity; market risk premia can only be generated over the cycle; stewardship adds value by protecting and improving returns and company sustainability practices; the asset owner has the capability and resources to pursue long-term approaches that integrate ESG and sustainability.

Benchmarks

- Though market capitalisation-weighted benchmarks reflect the average return, neither these nor fundamentally weighted benchmarks fully reflect long-term sustainability risk and opportunity.
- Asset owners with strong investment beliefs on sustainability, and sufficiently strong in-house resources, can use adjusted or tilted indices to mitigate systemic risk and capture company-specific opportunities.

Risk, tracking error and active share

- Investment strategies can encourage companies to focus more strongly on the long term and sustainability if they have high tracking error and high active share, and are benchmark agnostic or have unconstrained approaches to portfolio construction and stock selection. These factors enable managers to conduct deep research and allocate larger amounts of capital to each company. This sends clear signals to companies that investors value the long term and sustainability.
- If high active share and low tracking error are required, they can be achieved through sector weights that match the benchmark and stock selection within sectors.
- Risk, tracking error and active share targets or thresholds can be incorporated into mandates.

Turnover and holding periods

- Low turnover and long holding periods allow the investor to capture returns derived from longer term factors, including ESG.
- Holding periods in 'strong' LTRSI are likely to be at least five years and may be up to 10 years or beyond.
- Asset owners should expect managers to demonstrate how they have communicated to companies the fact that they take a long-term view.
- Low turnover reduces costs to the asset owner.
- Managers should explain any deviation from turnover expectations agreed at the inception of a mandate.

Portfolio size

- Smaller portfolios allow deep fundamental research and engagement that will encourage companies to take a long-term view and to focus on sustainability.
- A LTRSI portfolio is likely to be smaller than other portfolios – probably fewer than 75 stocks and possibly as few as 20–30.

Stewardship

- Stewardship is a crucial channel for communicating to companies that investors expect and value a focus on the long term and on sustainability.
- Asset owners should expect their asset managers to conduct regular dialogue with all companies in the portfolio, and to vote at all company meetings unless there are overriding reasons not to do so. Asset owners may also choose to conduct engagement themselves - in addition to, or instead of, engagement by their asset managers.
- Collaborative engagement by investors strengthens their ability to enhance long-term value and encourage sustainability.
- Investors should encourage alignment between executive remuneration and long-term performance, including links to relevant ESG factors.
- Where it is practiced, securities lending should follow the International Corporate Governance Network's Code of Best Practice.

Investment process and organisational culture

- The investment process should demonstrate deep research capability; team size is less important than team capability.
- Asset managers should be able to demonstrate how ESG is fully integrated and 'grows from within' the process rather than being 'inserted from outside'.
- There should be a strong culture of teamwork and learning from mistakes, to help ensure a disciplined investment process and the optimum use of information and knowledge.
- There should be strong governance of LTRSI processes – eg clear accountabilities and cross-organisation structures.
- Demonstrable supportive leadership from senior levels is needed in order to create a culture that 'long-term, responsible and sustainable investment is what we do here'.

Performance monitoring and reporting

- Performance should be monitored and reported in a way that encourages managers to focus on long-term financial performance and the sustainability characteristics of the portfolio.
- Performance should be monitored regularly, over both short and long periods (to identify early warning signals of any problems), but evaluated over periods of at least three to five years.
- Reporting by asset managers should demonstrate how sustainability is embedded within the investment process; explain stewardship activities; and illustrate the outcomes of stewardship.
- Suitable reporting indicators might include active share; turnover; share retention over five years; the proportion of companies with which engagement has been conducted; and sustainability quality metrics such as CO₂ intensity or ESG ratings.

Commercial model and fund manager incentives

- Fee structures should align the asset owner's interests with those of the asset manager – ie each should 'win' or 'lose' in parallel.
- Where performance fees are used, they should be simple, transparent and clearly incentivise long-termism.
- To discourage trading that does not add value for the client, a specified level of transaction costs could be included within basic management fees.
- Portfolio managers' bonuses should be weighted predominantly towards long-term performance (five years or more). Co-investment by portfolio managers in funds managed for the client helps to align interests.

Relationship between the asset owner and the manager

- A high degree of understanding and trust between the client and the asset manager is necessary for LTRSI. Clients may require patience before expected performance is achieved.
- Asset owners should communicate clearly their investment beliefs on long-termism and sustainability; how they expect managers to demonstrate alignment with these; and any specific factors in their circumstances that are relevant (eg member/beneficiary values).
- This information may be set out in a non-contractual covenant provided alongside the formal legal documentation for the mandate.

Part 1

Introduction

1.1 Purpose of this report

The mission of the Investment Leaders Group (ILG) is ‘to help shift the investment chain towards responsible, long-term value creation, such that economic, social and environmental sustainability are delivered as an outcome of the investment management process as investors go about generating robust, long-term returns’.

This report provides a toolkit for investors who wish to design investment strategies that can make a particularly strong contribution to this objective, or to assess the extent to which existing strategies contribute to it. We do this by focusing on investment time horizons and the extent to which sustainability factors are embedded in the investment process. First and foremost we address fundamental listed equity strategies, for the reasons explained below. For asset owners this toolkit will therefore be relevant to one particular part of their equity portfolio. For most asset managers it will relate to particular active equity strategies they offer.

Asset owners will be able to use the toolkit to design mandates with varying ‘strengths’ by adjusting the various characteristics described here to suit their particular needs, circumstances, belief in the investment significance of sustainability issues, desire to demonstrate responsibility as an investor, etc. They will be able to select and monitor managers who are aligned with their investment beliefs and expectations. Asset managers will be able to use the toolkit to design investment strategies that respond to the needs of asset owners who are demonstrating increasing interest in long-term investment that systematically takes account of sustainability risks and opportunities.

Each asset owner is unique. Each has its own specific investment objectives, linked to liabilities (eg for a defined benefit pension fund or an insurance company), or to deliver attractive outcomes for a given level of risk (eg for a defined contribution pension fund). To achieve these objectives, asset owners diversify their investments across a range of asset classes, risk factors, themes, strategies and time horizons. While in the aggregate they may take a long-term view – eg with some liabilities stretching over decades – parts of their portfolio need to have a shorter-term orientation (eg to meet near-term liabilities or satisfy regulatory liquidity requirements).

Strategies and mandates of the type discussed here will be possible and appropriate only in certain parts of a diversified asset owner’s portfolio. Nonetheless, the ILG believes that greater adoption of this approach could make a significant contribution to countering the negative business and economic effects of short-termism, and to promoting environmental and social sustainability.

1.2 Defining ‘long-term, responsible and sustainable investment’

Given its mission, and its focus on fundamental equity investment in particular, the ILG defines long-term, responsible and sustainable investment as:

Investment that promotes increased long-term value creation by companies and in the economy as a whole, and more sustainable business practices by companies. Investment of this kind is characterised by a clear and disciplined investment philosophy, process and culture, rather than a rigid set of rules or criteria.

It focuses principally on long-term factors that determine companies’ earnings, rather than short-term factors that may predominate in determining share prices. Its time horizon is likely to be five years or more. Committed stewardship is an integral part of long-term, responsible and sustainable investment.

Examples of other investors’ and commentators’ definitions of long-termism are provided for interest in Annex 1.

1.3 Why are investors' time horizons relevant?

Numerous studies point to short-termism by investors – the tendency to focus on short-term rather than longer-term returns, and the resulting pressure on companies to deliver returns that meet these expectations – as a source of underinvestment, economic inefficiency and poor decision-making by corporations that undermines long-term value creation.

Investor short-termism is also regularly cited as a barrier to companies making more progress towards sustainable business practices.² UN Global Compact companies “have acknowledged that emphasis on short-term financial performance means that they tend to prioritise investments that offer immediate returns over those where there is a significant time between capital being invested and returns being delivered (even if these investments provide a greater net present value), prioritise investments that provide tangible financial benefits over those that provide non-financial benefits (e.g. improved brand or reputation), and prioritise investments in research and development that relate to their core business areas, rather than those where the primary drivers are sustainability-related risks or opportunities. Even those companies with well-established sustainability strategies and programmes acknowledge that the effect is to reduce their total investments in sustainability-related activities, even those that are seen as critical to the longer term success of the company.”³

A brief summary of research on the prevalence, effects and causes of short-termism can be found in Annex 2.

Long-termism and sustainability are distinct concepts. Not all investment that is long-term is sustainable – for example if the costs of certain sustainability issues do not become material for companies even over long timescales. And investment does not need to take a long-term view in order for sustainability factors to be relevant: material impacts of some ESG issues are with us here and now, such as health and safety incidents, ethics breaches by banks and resulting fines, and increasingly frequent extreme weather events that are likely to be linked to climate change. These can all affect asset prices and prospects.

However, the two concepts are complementary for responsible investors in their search to maximise long-term value creation. The ILG firmly believes that sustainability issues can already affect company performance and investment returns – and that this trend will grow stronger in the coming years.

Long-term investment therefore requires a strong focus on sustainability – and vice-versa.

1.4 What are the advantages of long-termism for investors?

1.4.1 General advantages

The general advantages of long-termism for an investor can be seen as the opposite of the features of excessive short-termism highlighted in the research cited in Annex 2:

- A general increase in economic output and efficiency across companies as a whole
- Higher returns from individual companies within a portfolio as a result of holding periods that allow the investor to capture longer term value
- Opportunity to enhance value creation through engagement built on strong relationships with companies.

For asset owners in particular, further benefits include:

- Lower costs as a result of lower trading levels
- Ability to capture benefits of illiquidity, notably those derived from investing in asset classes such as infrastructure and private equity.

1.4.2 Financial performance

For equity funds, recent academic research suggests that low portfolio turnover is a significant determinant of outperformance by active managers, when it is combined with a high active share (the proportion of stocks in a portfolio that differ from those in the benchmark).⁴ The researchers find that “Only the most active and patiently managed funds have on average been able to outperform. [...] The outperformance of the most active and patient funds – the portfolio of mutual funds where both the Active Share and the Fund Duration⁵ are in the top quintile – is economically considerable and statistically significant. [...] these patient funds generated an annualised alpha of 2.05% after costs [...]. The most active mutual funds with short durations or who frequently trade generally underperformed their benchmarks by a considerable margin, across all levels of Active Share. We thus find that only active bets that were also patient (i.e. longer term) were rewarded in the markets, but find no evidence that active short-term bets were profitable.”

At the individual stock level, the first three years may account for as little as 14 per cent of total forecast free cash flow in a cash-flow valuation model. Investors who hold a stock for longer than this period may capture greater value. The research referred to above shows that the average fund duration among the investors studied was only 17 months – not enough to benefit to the full from longer term cash flows.

1.5 Our focus here – listed equity

1.5.1 Why listed equity?

All investors make two critical decisions that determine the extent to which they can deliver both social and environmental sustainability and robust long-term returns: how to invest capital, and how to conduct their ongoing relationship with an investee entity for as long as they remain invested. Asset classes offer differing opportunities to make these decisions in ways that help to achieve the twin objectives of the ILG's mission. All investors make capital allocation decisions in one form or another that may reflect views on sustainability risk and opportunities and send signals to investees that influence behaviour, and may in aggregate affect the composition of the market. Opportunities to exercise influence post-investment differ by asset class (see box).

How investors in different asset classes can influence investees

- Investors in listed equity have rights as shareowners and opportunities to influence company behaviour through voting and ongoing stewardship activities.
- Investors in unlisted asset classes – eg private equity, real estate, infrastructure or real assets such as farmland or timberland – may have greater opportunities to exercise influence, depending on the governance structure of the investment. General Partners (GPs) with board representation at portfolio companies have substantial influence. Asset owner Limited Partners (LPs) can exercise strategic influence over GPs if they are members of LP Advisory Committees. Smaller GPs and LPs have less influence.
- Fixed income investors can reflect their sustainability views by favouring one issuer – or issue – over another. However, their ability to exercise ongoing influence over the issuer is limited.

We focus here on listed equity, since it plays such an important part in asset owners' portfolios – and is therefore so significant to many asset managers – and offers substantial opportunities for investors to exercise influence to encourage long-term sustainability.

1.5.2 Listed equity strategies

Investors invest in public equity through many different strategies. These can broadly be classified into passive, quantitative (or rules-based) and active approaches. These in turn have many different varieties: passive investment via conventional market capitalisation-weighted indices or other indices, including a rapidly growing range of indices based on ESG factors; multiple different quant strategies; and active strategies that can be fundamental (bottom-up), top-down (by sector, region etc), and others. Fundamental investors have different time horizons: some focus on short-term company performance, while others take a longer term view. Each of these equity strategies can be accompanied by stewardship activity of varying intensity.

Each asset owner decides what part, if any, each of these strategies can play in meeting its financial return objectives. Each strategy may also contribute in different ways to the ILG's mission, through the financial returns it generates and through its impact in encouraging more sustainable business practice by companies. This latter effect is achieved through the signals the investor sends to company management in three ways:

- **Through the nature of the information required to support capital allocation decisions and the way this information is collected**

Investors who need sustainability information apply pressure for corporate disclosure of this information, and thus for improved corporate sustainability performance. Direct contact with companies during which sustainability information is requested provides a clear signal that this information is valued by those making investment decisions.

- Fundamental investors need detailed information on a company's business, strategy, exposure to sustainability risk and opportunity, etc. They usually meet companies as part of their pre-investment research process. Investors with long time horizons require information on factors that will affect company performance at more distant times in the future than short-horizon investors. This is likely to provide stronger incentives for long-term investors to seek information on a broader range of ESG factors, and to devote greater resources to their research process. Fundamental investors can reflect strong views (conviction) on sustainability in the investment positions they take. Longer term investors are therefore likely to provide stronger incentives for companies to address sustainability issues that may affect them at more distant points in the future.

- Quant investors use a range of financial and potentially other data points. If they use ESG information, this helps to stimulate demand for corporate disclosure and performance improvement. Quant investors have no direct contact with companies before they invest.
 - Passive investors need only to know which companies are in the index. Investors using passive indices that incorporate ESG information help to stimulate demand for disclosure via the index provider's use of sustainability data. Passive investors have no direct contact with companies before they invest.
- **Through their allocation of capital, which influences share prices**
 - Fundamental investors who incorporate ESG analysis into their investment process reflect companies' exposure to sustainability risk and opportunity in their capital allocation decisions. Investors with longer horizons are likely to attach greater weight to sustainability factors than those with short horizons.
 - Quant investors whose model incorporates sustainability factors reward companies with strong sustainability and financial performance and penalise those with weaker performance (assuming that their ESG signal shows that sustainability performance is positively related to financial performance).
 - Capital allocation by quant investors whose model does not explicitly take account of ESG factors does not reflect sustainability factors that are not currently priced by the market.
 - Passive investors in ESG-adjusted indices reward companies with strong sustainability and financial performance and penalise those with weaker performance. An important new development in this area is the Long-Term Value Creation Global Index recently launched by six large institutional investors and S&P (see box).
 - Passive investors in cap-weighted indices by definition simply follow the market. If sustainability factors and performance already affect share prices, passive investors' capital flows towards companies with good performance and away from those with bad performance. Capital flows do not reflect sustainability factors that are not currently priced by the market – eg because of the market's time horizon and its assessment of externalities, future regulation, stranded assets, etc.

The S&P Long-Term Value Creation Global Index

S&P Dow Jones Indices, in collaboration with Canada Pension Plan Investment Board and RobecoSAM, has created an index that seeks to provide exposure to global firms that are considered on track to create long-term value. The S&P Long-Term Value Creation (LTV) Global Index is designed to capture companies that seek to anticipate and manage current and future economic and governance opportunities and risks by focusing on long-term strategy, innovation, and productivity and that may be more likely to maintain a competitive advantage and thereby sustain stakeholder value. Companies that have demonstrated a sustained history of financial quality may likewise have the capacity to generate future long-term value; thus the S&P LTV Global Index has been constructed to identify companies having both of these characteristics – sustainability and quality – according to proprietary methodologies.

Much has been said about the short-termism in capital markets over the last few years. In the recent past, large institutional investors have expressed concern about short-termism and have proposed ideas to address the fundamental issues. They believe this trend may erode long-term value that is important for such investors, as they rely on robust future growth to meet their liabilities. The S&P LTV Global Index may be a useful performance benchmark to assist investors seeking to take a long-term approach to global equity investment.

The index methodology incorporates the Economic Dimension factors of RobecoSAM's Corporate Sustainability Assessment.⁶ This covers corporate governance; risk and crisis management; codes of conduct, including bribery and corruption; customer relationship management; brand management; stakeholder engagement and anti-crime policy.⁷

The index is calculated only at the end of each day and is not designed for tradeable short-term instruments.

Six large institutional investors have committed to invest ca. \$2 billion in funds using the index. The investors are ATP (Denmark), CPPIB, GIC (Singapore), New Zealand Super Fund, Ontario Teachers' Pension Plan, and PGGM (Netherlands).⁸

Source: S&P; Cambridge Institute for Sustainability Leadership

1.5 Our focus here - listed equity *continued*

- **Through their ongoing stewardship relationship with companies**

- Fundamental investors need ongoing contact with companies to support their investment decisions – eg to understand changes in companies' strategy and prospects. The questions these investors ask, and the changes in company practice that they advocate, send clear signals of their expectations, which can influence companies. Fundamental investors with longer time horizons are likely to encourage companies to focus on longer term factors that will affect performance, including sustainability.
- Passive investors hold companies for as long as they remain in the index (while adjusting the size of their position to reflect changes in market capitalisation). They are therefore (very) long-term investors in many companies. They do not need to maintain contact with companies to support their investment decisions. However, many passive investors attach importance to stewardship (engagement and voting) because they recognise its importance to long-term value creation and the performance of the market as a whole.
- Quant investors generally have short holding periods for the stocks in their portfolio (less than a year; often far less).⁹ They do not need to maintain contact with companies to support their investment decisions. They are unlikely to conduct stewardship activity (though some may exercise voting rights). However, engagement with companies in a quant portfolio may take place 'by default' if a quant fund is managed by an investment house that also has passive or fundamental funds for which it is conducting engagement and voting.

The strength of the signals encouraging companies to focus on long-term performance and sustainability issues that are conveyed by different equity strategies is summarised in the table below.

1.5.3 Fundamental active equity

The toolkit in Part 2 concentrates on fundamental active equity strategies. As the table below suggests, these equity strategies offer the potential to combine strong signals to companies in support of long-termism and sustainability in all three dimensions analysed – information collection to support investment decisions, capital allocation and stewardship.

The toolkit does not prescribe the specific features that an investment process and mandate 'must' have in order to encourage long-termism and sustainability. Rather, it allows investors to assess the extent to which various features of an investment strategy, individually and in combination, promote more sustainable business practices by companies and increased long-term value creation by companies and in the economy as a whole.

Equity strategies: signals for long-termism and sustainability

| | Long-termism and sustainability signal | | |
|------------------------------------------------|-------------------------------------------------------|------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| | Information needed for investment decisions | Capital allocation | Stewardship |
| Passive: market-cap weighted index | None (index composition only) | Weak | Weak/medium/strong – dependent on intensity of activity |
| Passive: sustainability/ESG index | Medium (via data provider) | Medium/strong – dependent on index | |
| Quant | None (if no ESG data used) Weak (if ESG data used) | | None/weak (some quant managers exercise voting rights; stewardship may be undertaken for other funds run by the same manager: strength of signal depends on intensity of activity) |
| Fundamental: short-term (1–3 years) | Medium | Weak/medium | Weak/medium/strong – dependent on intensity of activity |
| Fundamental: long-term (>5–10 years) | Strong | Strong | Strong – dependent on intensity of activity* |

*A portfolio manager running a long-term fundamental strategy has a strong incentive to encourage companies to focus on long-term performance, including relevant sustainability factors. The extent to which this exercises influence over companies may depend on factors including the size of the manager's portfolio (ie the amount invested); the amount invested in the company by other funds run by the same investment house; and the intensity of the stewardship undertaken (eg number of meetings, insistency of arguments, etc).

Part 2

Toolkit

2.1 How to use this toolkit

The following sections discuss the principal steps in the development and design of a fundamental long-only equity investment mandate that serves the objective of long-term, responsible and sustainable investment.

These highlight the options that are available, and indicate the extent to which different choices and approaches may contribute to a greater or lesser extent to the objective. We cover:

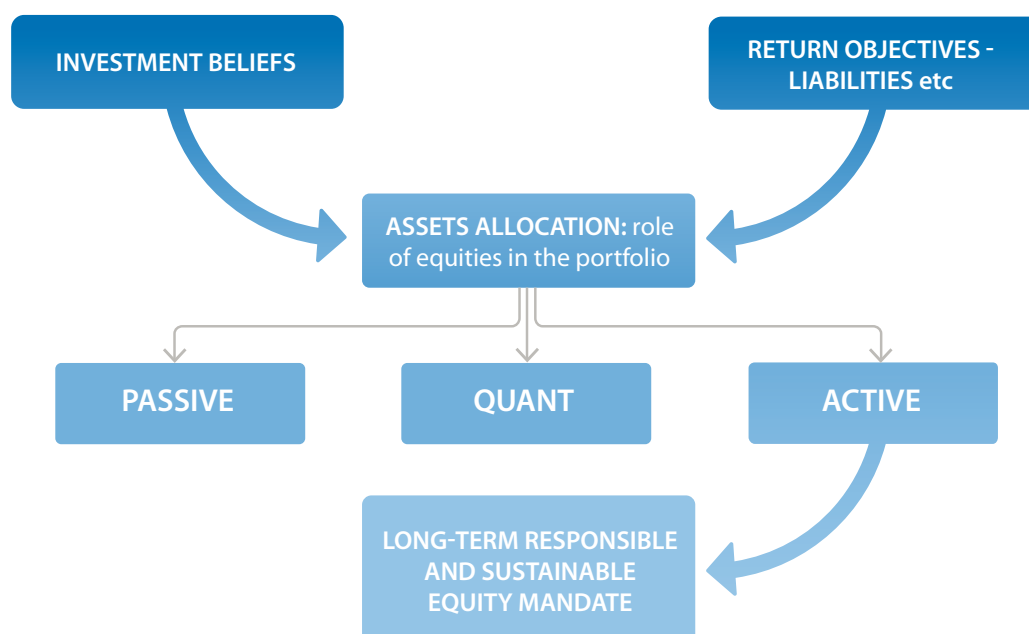
- Investment beliefs: the top-level strategic beliefs that will provide a foundation for designing and implementing the mandate
- Determining the part that equities and long-term active equities will play in the portfolio
- The key design features of the mandate:
 - choice of a benchmark
 - risk, tracking error and active share
 - turnover and holding periods
 - portfolio size
- Stewardship
- The investment process and organisational culture of the fund manager

- Performance monitoring and reporting
- The commercial model and fund manager incentives
- Building a relationship of trust between the asset owner and the fund manager.

The charts below summarise the process by which an asset owner decides to implement an LTRSI active equity mandate, and the key design features of such a mandate that can be adjusted to suit the asset owner's individual needs and to create different 'strengths' of LTRSI.

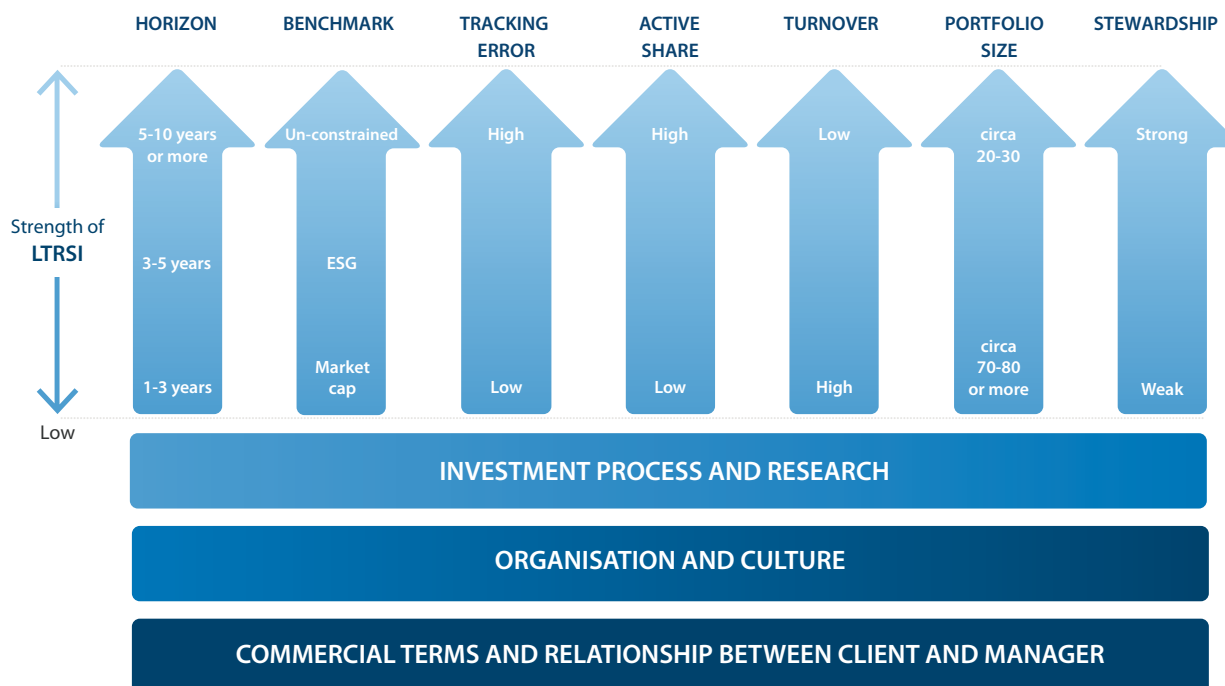
It is important to note that the design features should not be viewed independently, but are related to each other. For example, a portfolio of 70–80 stocks may have high or low turnover according to its investment strategy and style, and it may be supported by research and stewardship of varying depth and intensity.

Figure 1: Deciding to implement a long-term, responsible and sustainable equity mandate



2.1 How to use this toolkit *continued*

Figure 2: Building blocks of long-term, responsible and sustainable investment



2.2 Investment beliefs

Key points

- Asset owners should set out their investment beliefs on long-term investment and sustainability.
- Successful implementation of LTRSI will be supported by beliefs that long-termism is conducive to value creation by companies and in the economy; ESG issues are sources of long-term (as well as shorter term) risk and opportunity; market risk premia can only be generated over the cycle; stewardship adds value by improving returns and company sustainability practices; the asset owner has the capability and resources to pursue long-term approaches that integrate ESG and sustainability.

2.2.1 Background

Investment beliefs are “assertions about investments and the way the investment world works which, when developed and shared, help with investment decision making”.¹⁰ Well-articulated investment beliefs that the board and management of an asset owner organisation understand and truly believe in are recognised as a cornerstone of good governance and long-term investment. It is now widely accepted that it is good practice for an asset owner to set out its investment beliefs clearly, as an anchor for investment decisions. Unless the asset owner has clear long-term investment philosophy and beliefs, sufficient knowledge and understanding of the advantages and challenges of long-termism, and the governance capability to set and monitor long-term mandates (eg to withstand periods of benchmark-relative underperformance), the alignment of interests between the asset owner/client and the manager that is essential for long-term investing will be difficult to achieve.

Clear investment beliefs enable asset owners to identify managers who share their approach to investment, by making it explicit to the asset owner itself what that approach is.

2.2.2 Potential investment beliefs

By definition, investment beliefs are the views held by a particular institution. They cannot be imposed from outside. They represent explicit and codified expressions of the assumptions an institution makes about how it should invest, and the principles it follows as a result. The development of investment belief statements usually involves extensive discussion at the governing body level, and between the governing body and an asset owner’s executive staff.¹¹ However, asset owners that are able to take a long-term approach with a strong focus on sustainability are likely to hold investment beliefs that reflect one or more of the following statements:

- Long termism in financial markets is conducive to long-term value creation in the economy.
- Taking a long-term investment approach encourages investee companies to be more long term.
- Market risk premia in general can only be generated over the cycle.
- Active returns related to long-term ESG trends can only be realised over long holding periods.
- Certain ESG issues represent long-term systemic risks.
- Companies with a long-term approach outperform companies with a short term approach, on both financial and sustainability KPIs.
- Short-termism creates unwanted externalities that may harm long-term returns.
- The long term is more than just the sum of incremental short-term horizons.
- Long-term investment outcomes are driven by company fundamentals, as opposed to a series of short-term fluctuations, driven by sentiment and irrationality.
- Stock prices revert to their fundamental value over the long term.
- As a long-term investor, we are able to hold stocks for a long period and do not have to make shortsighted decisions in response to market fluctuations.
- Committed stewardship adds value to investments and is a responsibility of the investor.
- Investors can protect their long-term returns by engaging with policymakers on market-wide risk issues.
- Long-term, responsible and sustainable investment is consistent with fiduciary duty.
- As an organisation we have the capabilities and resources required to take a long-term approach with a strong focus on sustainability.

2.3 What part will long-term active equities play in the portfolio?

Asset owners use fundamental equities to provide returns in excess of the risk-free rate and alpha in excess of the return on a passive portfolio. ILG asset owner members describe in their own words the part that fundamental equities play in their asset allocation.

Asset allocation and long-term investing in ILG members' own words.

“With a market based product we wish to have a robust portfolio providing stable real returns well above the risk-free rate, regardless of investment environment. The individual risk is decreased according to the time to retirement meaning equities will have a larger role for younger members. A passive equity strategy is a cheap way of taking on risk in a more tactical allocation, while an active strategy can focus on desirable company characteristics for a pension fund portfolio such as stable returns. An active equity strategy also gives members exposure to alpha while the longer holding period insulates from short-term market deviations.”

Asset owner 1

“Systematic risk premia (beta) can only be earned over the market cycle. As an insurance investor, our starting point in long-term investing is to determine an asset allocation which is in line with our risk-bearing capacity (ie liabilities and capital allocated to investment risk-taking) and avoids pro-cyclical behaviour (de-risking at the bottom; re-risking at the top of the market cycle). All of this can in theory be achieved with passive (ie indexed) strategies. There are thus two qualities to long-term investing: one top-down, about ALM and SAA, and one bottom-up, about security selection and active ownership.”

Asset owner 2

2.4 Benchmarks

Key points

- Market capitalisation-weighted benchmarks and fundamentally weighted benchmarks do not fully reflect long-term sustainability risk and opportunity.
- Asset owners with strong investment beliefs on sustainability, and strong in-house resources, can use adjusted indices to mitigate systemic risk and capture company-specific opportunities.

2.4.1 Conventional vs alternative benchmarks

Asset owners' return objectives are usually expressed in relation to their liabilities, which are in turn often linked to inflation (eg via bond yields). However, in order to set objectives and monitor performance for their investment managers, they usually use benchmarks that represent the composition of the investable universe of listed companies. The choice of a benchmark for an investment mandate plays an important part in determining the contribution the mandate can make to the objectives of LTRSI. Although other approaches have been developed in recent years, the most widely used benchmarks are based on companies' market capitalisation: a company's weighting in the index that is used as the benchmark is determined by its market capitalisation.

Traditional market-cap weighted benchmarks have the advantage of being readily investable and of allowing the asset owner to hold the manager to account more easily, by assessing their ability to add value compared with a widely used passive alternative, and by comparing them with other managers.

However, conventional cap-weighted benchmarks do not take full account of companies' likely performance in the face of long-term sustainability trends. These factors are reflected in the index weightings only to the extent that they are already recognised and priced by the market. By definition, the largest constituents of current market cap-weighted equity indices are the companies that are the largest and most successful in today's economy. Even if their growth prospects are lower than those of other companies – in relation to their current size – they continue to attract large weightings and therefore large allocations of investors' capital.

Some of these – such as oil and gas companies – may be particularly exposed to systemic sustainability risks (eg climate change). Managers whose performance is measured relative to a market-cap weighted index may have less incentive to consider these risks because the benchmark itself is exposed to the risk. Other companies may have poor performance on specific ESG issues that expose them to idiosyncratic (stock-specific) risk. Conversely, smaller companies that have low weightings in existing benchmarks, or which are not included in them at all, may have strong growth prospects linked to sustainability.

If a market-cap weighted benchmark is used with a tight tracking error constraint, managers will be limited in their ability to express strong conviction in companies' sustainability prospects and credentials. This will reduce the manager's incentive to conduct deep sustainability research on companies or intensive ongoing engagement with them – thereby reducing incentives for companies to give priority to improving sustainable business practice.

Evidence continues to emerge of positive links between company financial performance and sustainability characteristics.¹² Asset owners who have strong investment beliefs on sustainability and ESG can take responsibility for mitigating risks linked to these issues by using benchmarks that are adjusted to take account of them. A growing range of such indices is available from the main index providers.

These indices are currently used principally for passive investment strategies. However, they can also be used as benchmarks for active investment. Here they will represent a test of a manager's skill managing risk and adding value over and above what is already secured by the construction of the index itself.

2.4.2 Unconstrained strategies

Managers who are benchmark agnostic in their portfolio construction and stock selection may have stronger incentives to assess a wide range of systemic and idiosyncratic sustainability risks over long time horizons. This is because their performance will be affected by the full impact of a systemic risk that crystallises, not just by that portion that is over and above the impact on the benchmark.

2.5 Risk, tracking error and active share

Key points

- Investment strategies can encourage companies to focus more strongly on the long term and sustainability if they have high tracking error and high active share, and are benchmark agnostic or have unconstrained approaches to portfolio construction and stock selection. These factors enable managers to conduct deep research and allocate larger amounts of capital to each company. This sends clear signals to companies that investors value the long term and sustainability.
- If high active share and low tracking error are required, they can be achieved through sector weights that match the benchmark and stock selection within sectors.
- Risk, tracking error and active share targets or thresholds can be incorporated into mandates.

Monitoring risk is central to an asset owner's overall monitoring of its investment managers. The way risk is defined can have significant implications for the objectives of long-term, responsible and sustainable investment.

Monitoring risk is central to an asset owner's overall monitoring of its investment managers. The way risk is defined can have significant implications for the objectives of LTRSI.

LTRSI in fundamental equity investment requires a high tolerance for tracking error (active risk). Tight tracking error limits lead to more index-like portfolios with lower active share. As noted earlier, research shows that portfolios with high active share and low turnover outperform.

Managers who are not able to deviate far from the benchmark will have limited scope to reflect strong sustainability conviction in their investments. This will limit the manager's incentives to conduct deep research on long-term and sustainability factors, potentially encourage exposure to unrewarded systemic risk (eg climate change and stranded assets), and limit the investment of capital in companies with the strongest performance and prospects in these areas. An unconstrained or benchmark agnostic philosophy will encourage the opposite. To the extent that systemic risks manifest over the long term, and assuming the timing is difficult to predict, defining risk in absolute terms may encourage a more long-term approach.

If an unconstrained or benchmark agnostic approach is followed, a benchmark still can be used for performance monitoring and evaluation so that the asset owner can assess the manager's skill by comparison with the market as a whole and other managers.

If high active share and low tracking error are required, they can be achieved if the portfolio exhibits the same sector weights as the benchmark but focuses on best-in-class stock selection within the sector. The portfolio's exposure to systemic risk factors will be the same as the benchmark, hence it will have low tracking error. Alpha will be generated through company-specific analysis. This approach will have higher systemic sustainability risk exposure and provide less opportunity for capital allocation based on strong sustainability views.

2.6 Turnover and holding periods

Key points

- Low turnover and long holding periods allow the investor to capture returns derived from longer-term factors, including ESG.
- Holding periods in 'strong' LTRSI are likely to be at least five years and may be up to 10 years or beyond.
- Asset owners should expect managers to demonstrate how they have communicated to companies the fact that they take a long-term view.
- Low turnover reduces costs to the asset owner.
- Managers should explain any deviation from turnover expectations agreed at the inception of a mandate.

A portfolio that takes a long-term view on company performance is likely to have a lower turnover and longer holding periods than one with a shorter-term view.

A portfolio that takes a long-term view on company performance is likely to have a lower turnover and longer holding periods than one with a shorter-term view. This flows from a recognition that returns derived from company fundamentals, including those linked to sustainability factors, are more likely to be achieved over longer periods that represent one or more full market cycles.

Shorter holding periods may incentivise companies to adopt shorter-term strategies – and to give less attention to sustainability. ESG issues linked to longer term trends and with high uncertainty regarding relevant scenarios (eg climate change, resource scarcity, social inequality) are more likely to be addressed in long-term strategies than in short-term strategies. More idiosyncratic factors, such as health and safety, governance, etc, which can materialise at any time, should be reflected in the investment process irrespective of any term. The longer an investor holds a company, the greater the likelihood becomes that an incident linked to a factor of this kind will occur.

Holding periods in LTRSI strategies are likely to be at least five years and may be up to 10 years or beyond. At the same time, valuation will remain the ultimate driver of investment decisions. This will override expected holding periods or turnover targets. Turnover to increase or reduce the size of long-term positions should also be expected (though monitored).

Companies that are aware that their shareholders take this longer term view will be able to make longer term strategy decisions. Asset owners should therefore seek strong evidence from managers on how they communicate their strategy and position clearly to companies.

Low turnover also means that trading costs will be low – thereby reducing the drag on the portfolio's performance.

Asset owners should expect their managers to explain the relationship between portfolio turnover (overall turnover and names – ie buying/selling entire positions in companies), holding periods and the objectives of LTRSI, and any deviations from the expectations agreed at the inception of the mandate.

2.7 Portfolio size

Key points

- Smaller portfolios allow deep fundamental research and engagement that will encourage companies to take a long-term view and to focus on sustainability.
- A LTRSI portfolio is likely to be smaller than other portfolios – probably fewer than 75 stocks and possibly as few as 20–30.

There is no ‘correct’ size for a portfolio that is focused on long-term fundamental value creation and sustainability. However, the ILG believes that deep fundamental research by investors provides the strongest incentives to companies to take a long-term view and to adopt more sustainable business practices (particularly when this is combined with committed stewardship – see section 2.8). The larger the number of stocks in a portfolio (or a research universe), the more difficult it will be for a manager to conduct thorough fundamental research without incurring unacceptable costs. Portfolios based on the approach we are exploring here are therefore likely to be smaller than many conventional mainstream equity portfolios – probably fewer than 75 stocks and possibly as few as 20–30. Statistically, an absolute return-focused strategy requires only about 25–30 stocks with an average degree of non-correlation to diversify away most of the non-systematic risk in a portfolio.¹³

Asset owners should expect asset managers to explain how the number of stocks in the portfolio relates to their ability to conduct adequate fundamental research and to achieve the objectives of the investment approach explored here.

2.8 Stewardship

Key points

- Stewardship is a crucial channel for communicating to companies that investors expect and value a focus on the long term and on sustainability.
- Asset managers should be expected to conduct regular dialogue with all companies in the portfolio, and to vote at all company meetings unless there are overriding reasons not to do so.
- Investors should encourage alignment between executive remuneration and long-term performance, including links to relevant ESG factors.
- Where it is practiced, securities lending should follow the International Corporate Governance Network’s Code of Best Practice.

Committed stewardship (engagement and voting) activity is an integral part of LTRSI. It is a critical channel for communicating to companies that investors expect and value a focus on a company’s long-term performance and on sustainability. Long-term investors are particularly well placed to develop close, ongoing relationships with companies that enable them to generate insights that can be incorporated into investment decisions and to exercise influence for improved management of long-term value creation factors, including those relating to sustainability.

2.8.1 Dialogue with companies

Asset managers should be expected to conduct regular dialogue with all companies in the portfolio. This should focus primarily on long-term performance factors, not short-term results and prospects. Dialogue with companies structured around results announcements and standard company ‘roadshow’ meetings may not allow sufficient opportunities to explore these issues in the required depth, or to meet a sufficiently wide range of company representatives. Asset managers should also be able to demonstrate what action they have taken to communicate their expectations for improvements in sustainable business practice, and the results they have achieved – alone and in collaboration with other investors – in such situations.

Indicators of a best practice approach to company dialogue and engagement include:

- Publicly available policy on engagement and proxy voting that explicitly sets out long-term investment and sustainability priorities.
- Regular engagement with all companies in the portfolio.
- Systematic record-keeping of engagement activity, including objectives and outcomes.
- Collaborating with industry bodies and NGOs when engaging.
- Analysts/PMs are involved in stewardship processes, integrating ESG into direct exchanges with investee companies, and being consulted for proxy voting purposes.
- Ability to explain how the insights from stewardship have affected investment views and decisions.
- 100 per cent proxy vote coverage. Automation of proxy vote process, but retaining responsibility for votes.

2.8.2 Executive remuneration

The way company executives are remunerated is a crucial factor in determining whether corporate strategy focuses on long-term value creation and sustainability. Bonus structures that direct insufficient attention to the long term will not serve the objectives of LTRSI.

Asset managers should be able to explain to their clients how their approach to executive remuneration at the companies in the portfolio supports the objectives of LTRSI. Executive pay should incentivise company management to focus on sustainability and long-term value creation. Conventional performance metrics such as total shareholder return over short periods (one to three years) do not provide such incentives. Longer term approaches include:

- Three-year performance periods for cash bonuses¹⁴
- Linking the vesting of share-based pay to underlying performance metrics such as return on invested capital and growth of the business¹⁵
- Linking pay to relevant sustainability performance¹⁶

- Vesting periods for share-based remuneration should reflect genuinely long-term performance – ie more than three years¹⁷
- Requiring management to make a material long-term investment in the shares of the company, with shares held for at least 10 years, even when the executive is no longer in post.¹⁸

2.8.3 Voting and securities lending

Exercising voting rights is a fundamental shareholder responsibility: it is central to good stewardship. It is therefore a crucial component of LTRSI. Securities lending improves market liquidity, reduces the risk of failed trades, and adds significantly to the incremental return of investors. However, in certain circumstances it may undermine shareholders' ability to exercise good stewardship – eg if stock is on loan and unavailable for voting when particularly important matters arise.

Indicators of best practice in voting and securities lending that are aligned with LTRSI include:

- Managers should vote at every company in the portfolio, unless there are legitimate reasons not to do so (eg share blocking or disproportionate cost).
- Voting on dividends and share buybacks should take account of the need to promote a long-term focus – eg with sufficient levels of investment in R&D and innovation, including in areas such as energy and resource efficiency, human capital development, etc.
- Voting on environmental and social issues that promotes improved sustainability performance and long-term value creation.
- Securities lending should follow best practice as set out by the International Corporate Governance Network.¹⁹

2.9 Investment process and organisational culture

Key points

- The investment process should demonstrate deep research capability; team size is less important than team capability.
- Asset managers should be able to demonstrate how ESG is fully integrated and 'grows from within' the process rather than being 'inserted from outside'.
- There should be a strong culture of teamwork and learning from mistakes, to help ensure a disciplined investment process and the optimum use of information and knowledge.
- There should be strong governance of LTRSI processes – eg clear accountabilities and cross-organisation structures.
- Demonstrable supportive leadership from senior levels is needed in order to create a culture that 'long-term responsible and sustainable investment is what we do here'.

An investment process geared towards the objectives discussed here should be based on comprehensive fundamental research into the factors that will determine companies' long-term earnings, including those linked to sustainability at both a company-specific and systemic level. A supportive, collaborative team culture is required to enable research findings to be used effectively and consistently.

The characteristics are likely to include:

- Strong in-house research capability, with or without separated analyst and PM roles.
- A team whose size is less important than demonstrated capability.
- Use of non-traditional external research sources – ie not just sell-side. Examples include independent industry and sustainability specialists, companies' customers and suppliers, employee representatives.
- Contacts with a wide range of company representatives – not just CEO, CFO, investor relations.
- Integration of sustainability/ESG research. Particular indicators of best practice may include:
 - Ability to articulate how ESG 'grows from within' the investment process rather than being 'inserted from outside'
 - Demonstration of how ESG issues that are material over different timescales and for different sectors are identified
 - Systematic demonstration of how ESG factors affect valuations, industry analysis, country analysis and other research. There is no single 'correct' way of doing this. Managers should be able to provide coherent explanations, with up-to-date stock-specific examples of how ESG research has contributed to investment decisions, and evidence that formal research processes are in place and have been followed.
- Written investment cases for all stocks held, incorporating relevant ESG issues.
- Strong culture of collaboration and information-sharing. The asset manager should be able to demonstrate teamwork and a strong understanding of sustainability throughout relevant teams.
- Culture of learning from mistakes.
- Strong governance of LTRSI activity – eg clear accountabilities and cross-organisation structures.
- Strong supportive leadership from senior levels: an organisational culture that 'long-term responsible and sustainable investment is what we do here' (eg regular communication from senior management that 'sets the tone'; LTRSI approach reflected in human resources and recruiting practices).

2.10 Performance indicators and monitoring

Key points

- Performance should be monitored and reported in a way that encourages managers to focus on long-term financial performance and the sustainability characteristics of the portfolio.
- Performance should be monitored regularly, over both short and long periods (to identify early warning signals of any problems), but evaluated over periods of at least three to five years.
- Reporting by asset managers should demonstrate how sustainability is embedded within the investment process; explain stewardship activities; and illustrate the outcomes of stewardship.
- Suitable reporting indicators might include active share; turnover; share retention over five years; the proportion of companies with which engagement has been conducted; and sustainability quality metrics such as CO₂ intensity or ESG ratings.

2.10.1 Monitoring and evaluation frequency

Financial performance monitoring should encourage managers to focus on long-term fundamentals, including sustainability issues that will affect companies over longer timescales and/or are systemic. As managers convey this performance expectation to companies, companies will in turn be encouraged to focus more strongly on long-term sustainability.

Performance should be monitored regularly (to identify early warning signals) and over various time intervals (short and long term), but evaluated over long periods, eg three to five years at least. The period over which performance is measured should also be cognisant of the style of the manager, and whether the investment period in question was conducive to the manager style (eg value/growth), especially if the benchmark is not style-adjusted. Between formal evaluations, managers should be able to demonstrate that they are remaining true to their investment process and philosophy.

2.10.2 Performance indicators and reporting

Both financial and sustainability performance indicators should reflect an appropriate balance between long and shorter term performance. Performance indicators should convey meaningful information about progress towards the asset owner's long-term objectives, while also enabling the client to hold the manager to account on a shorter term basis.

In the long term the most important factor for company returns is sustainable growth of earnings per share. Measures for individual companies such as return on equity, return on invested capital and cash flow – alongside shorter term metrics such as share prices – will enable asset managers to monitor the underlying financial health of the portfolio. These metrics should be measured over at least a full market cycle – eg five years or more²⁰ – and against industry peers. Asset owners should expect asset managers to monitor these indicators, and may request information on developments.

A wider view of the portfolio and the manager's performance in relation to LTRSI is provided by monitoring and reporting indicators such as active share, turnover and share retention over five years (the percentage of companies that have stayed in the portfolio for more than that period) and the proportion of companies in the portfolio with which the manager has engaged.

Sustainability indicators should also be monitored and reported, in order to track the sustainability health and progress of the portfolio, and the relationship between sustainability performance and financial performance at the company and portfolio level. Various indicators can be used to show the sustainability performance of individual companies and portfolios as a whole, in absolute terms and relative to a benchmark. Even if the portfolio does not use a conventional index as the benchmark, monitoring sustainability performance compared with an index can provide valuable information on the sustainability characteristics of the portfolio. Currently available indicators include:

- Carbon intensity – for individual stocks and portfolios as a whole
- ESG ratings – at an aggregate level, and for individual ESG issues that are material to specific companies. Ratings/scores may be proprietary to the asset manager or supplied by a specialist research provider.

The ILG has also developed a framework for measuring and reporting the environmental and social impact of portfolios. A group of UK asset owners has recently proposed a reporting model for the ESG dimension of long-term sustainable and responsible investment. This covers reporting on how ESG is integrated into the investment process through the identification and management of ESG risk and opportunity; and stewardship.²¹

2.11 Commercial model and fund manager incentives

Key points

- Fee structures should align the asset owner's interests with those of the asset manager – ie each should 'win' or 'lose' in parallel.
- Where performance fees are used, they should be simple, transparent and clearly incentivise long-termism.
- Portfolio managers' bonuses should be weighted predominantly towards long-term performance (five years or more). Co-investment by portfolio managers in funds managed for the client helps to align interests.

The way portfolio managers and analysts are incentivised is just as important as the commercial model between the client and the fund management organisation.

Fee structures should aim to align interests between asset owner and manager. ILG asset owner members take different approaches to fee structures. One uses only flat fees. Another uses a combination of base and performance fees, which it believes incentivises outperformance. Where performance fees are used, their structure should be simple, with a limit on the degree of asymmetry. Performance fee structures should incentivise long termism through eg high water marks and long time horizons for measuring performance.

The way portfolio managers and analysts are incentivised is just as important as the commercial model between the client and the fund management organisation. Portfolio manager bonuses should be based on long-term performance (five years or more). Where a proportion of the bonus is paid for shorter term performance, the overall weighting should be towards the longer term.

Qualitative factors should also play a part in performance-related pay. A significant proportion of the annual incentive should be based on an evaluation of factors such as the portfolio manager's or analyst's contribution to teamwork and whether they have systematically evaluated ESG issues and incorporated relevant dimensions into investment decisions and research.

Co-investment in a fund by the fund manager aligns interests between client and manager (eg a requirement to invest bonuses in the fund). If performance measurement and vesting periods are sufficiently long, it can also encourage long-termism, and potentially the pursuit of absolute returns over relative returns.

2.12 Relationship between the asset owner and the manager

Key points

- A high degree of understanding and trust between the client and the asset manager is necessary for LTRSI. Clients may require patience before expected performance is achieved.
- Asset owners should clearly communicate their investment beliefs on long-termism and sustainability; how they expect managers to demonstrate alignment with these; and any specific factors in their circumstances that are relevant (eg member/beneficiary values).
- This information may be set out in a non-contractual covenant provided alongside the formal legal documentation for the mandate.

A high degree of understanding and trust between the client and the asset manager is necessary for long-term, responsible and sustainable investment.

A strong relationship of trust between the asset owner and the manager is essential for the investment strategy described here. It is important that each party understands the other as fully as possible.

Approaches to achieving this include:

- Transparent communication by the asset owner of its investment beliefs and expectations on long-termism and sustainability, and how these relate to its particular circumstances. For example, a pension fund for employees in a particular sector may wish to demonstrate alignment with their values. This may make specific sustainability issues particularly salient for the asset owner.
- Explanation of what part the mandate plays in the asset owner's portfolio as a whole, eg in relation to investment horizons and how sustainability issues are addressed in different parts of the portfolio.
- Explanation by the asset owner of the factors on which evaluation of the manager is based (in addition to financial performance), eg how/whether the manager remains true to its stated investment process; how ESG is addressed; stewardship activities; the stability of the team; team and organisational culture, etc. The asset owner may describe the factors that will contribute to a decision to continue or terminate the relationship with the manager.

This information might be set out in a written covenant by the asset owner that is put in place alongside the formal contractual documentation.²² The asset owner should ensure that these issues are reviewed regularly during its ongoing relationship with the manager, to ensure that expectations remain aligned.

Part 3

Next steps

Asset owner members of the ILG will consider how best to incorporate the recommendations of this report into the way they design investment strategies and mandates, and into their approach to selecting and monitoring asset managers. Asset manager members of the ILG will consider the implications of the recommendations for active equity strategies they already manage for their clients. They may also explore the development of new investment strategies based on the recommendations.

Annex 1: Definitions of long-term investment

Focusing Capital on the Long Term

Focusing Capital on the Long Term (FCLT) is an initiative ‘for advancing practical actions to focus business and markets on the long term’. Its members include the Chairmen/CEOs/CIOs of Canada Pension Plan Investment Board, APG, PGGM, BlackRock, Ontario Teachers’ Pension Plan, Caisse de Dépôt et Placement du Québec, New Zealand Superannuation Fund, Capital Group, ATP, Wellcome Trust, Barclays, Standard Chartered, and Unilever.

FCLT argues that long-term investing:

- Is a state of mind rather than a holding period, and a culture rather than a directive
- Is about making investment decisions with a sustainable future-oriented perspective
- Takes advantages of opportunities created and/or unable to be taken by short-term investors
- Emphasises process and fundamental long-horizon corporate research rather than focusing solely on quantitative data analyses
- Requires persistence through periods of short-term underperformance and reaps the rewards of patience
- Is not a continuing sequence of short-term investments nor simply about buying and holding assets
- Is not driven by rankings or benchmarks (it is not a ‘beauty contest’), but focuses on long-term expectations and outcomes
- Is consistent with the time horizons and ultimate needs of most savers by providing asset owners with the ability to meet liabilities today and for many years in to the future.²³

Centre for International Finance and Regulation

Australia’s Centre for International Finance and Regulation²⁴ identifies two key defining characteristics of investment horizon:

- Discretion over trading: long-term investors have the ability to avoid trading when the investor might not otherwise have done so, and thus the ability to maximise value over time
- How investment decisions are made, notably a focus by long-term investors on information relevant for future outcomes over an extended period.

“Long-term investing is less about time frame and more about alignment with long-term objectives of the investor and long-term structural trends (eg climate change).”

Annex 1: Definitions of long-term investment *continued*

The author of the study writes:

The main concern of a long-term investor should be long-term outcomes. In many cases, this will entail considering the cash flows that an asset can generate over the long run, relative to the price that is paid for that cash flow stream... That is, long-term investors focus on the drivers of long-term value and long-term returns. In an equity market context, relevant information is that which sheds light on aspects such as earnings potential, sustainable competitive advantage, future investment opportunities, management alignment and competency, and so on.

A long-term investor will pay attention to this type of information, and filter out the short-term noise. ...

By contrast, short-term investors are primarily concerned with the drivers of price. The very simple reason is that short-term returns are dictated by price fluctuations. Such investors would hence focus on aspects such as news flow, how the market may respond to earnings announcements, the actions of other investors, current market themes – anything that could result in a price reaction.

The difference between short-term and long-term investors is closely related to the concept of ‘trading’ versus ‘investing’.²⁵

Other definitions

- “A long-term investor does not base investment decisions solely on the returns expected over short time periods of, say, a year or two.” (New Zealand Superannuation Fund).²⁶
- “Long-term investing is less about time frame and more about alignment with long-term objectives of the investor and long-term structural trends (eg climate change). It is when you invest with an interest in the cashflow-generating potential of the investment over the long term. It is not a buy and hold strategy. Investors who are permanently invested in equity indices are not long-term investors, even if they have low turnover/no turnover.” (Unnamed asset owner).²⁷
- “Short-termism is an investment strategy based on responding to price change rather than fundamental value.” (Prof Paul Woolley, London School of Economics, Director of the Centre for Capital Market Dysfunctionalities and former fund manager).²⁸
- In a recent survey of 36 pension funds by the magazine *Investments and Pensions Europe*, a quarter of respondents defined long-term investing in public markets as taking a three to five-year view. A third saw it as a seven to 10-year view. Only six were prepared to take a “generational view” of 15 years or more. “A decade is a period of time we consider as suitable to define long term,” said an Austrian fund. “On one hand, not many investments have a longer lifetime and, on the other, it matches with the liabilities based on our business model.”²⁹

Annex 2: The prevalence, effects and causes of short-termism

Short-termism, companies and the economy

Numerous studies and inquiries point to short-termism by companies as a source of underinvestment, economic inefficiency and poor decision-making that undermines long-term value creation. This is ascribed to pressure from investors for short-term corporate performance, manifested in part by high levels of trading. This, it is argued, undermines long-term investors' own interests.

- A 2013 survey by McKinsey and the Canada Pension Plan Investment Board of more than 1,000 company board members found that:
 - 63 per cent of respondents said the pressure to generate strong short-term results had increased over the previous five years
 - 79 per cent felt especially pressured to demonstrate strong financial performance over a period of just two years or less
 - 44 per cent said they use a time horizon of less than three years in setting strategy
 - 73 per cent said they should use a time horizon of more than three years
 - 86 per cent declared that using a longer time horizon to make business decisions would positively affect corporate performance in a number of ways, including strengthening financial returns and increasing innovation.³⁰
- Research by Graham, Harvey and Rajgopal published in the CFA Institute's Financial Analysts' Journal found that "the majority of managers would avoid initiating a positive NPV project if it meant falling short of the current quarter's consensus earnings. Similarly, more than three fourths of the surveyed executives would give up economic value in exchange for smooth earnings. Managers believe that missing an earnings target or reporting volatile earnings reduces the predictability of earnings, which in turn reduces stock price because investors and analysts dislike uncertainty."³¹ However, other research finds that this link is by no means clear, and that the greatest source of pressure to deliver short-term results (two years or less) arises from internal sources such as the board, rather than investors.³²
- The Kay Review of Equity Markets and Long-term Decision Making commissioned by the UK government in 2012 found "a tendency to under-investment, whether in physical assets or in intangibles such as product development, employee skills and reputation with customers, and hyperactive behaviour by executives whose corporate strategy focuses on restructuring, financial re-engineering or mergers and acquisitions at the expense of developing the fundamental operational capabilities of the business". The Review ascribed this to the lack of appropriate engagement by long-term shareholders, as a result of an excess of trading activity based on expectations of likely short-term share price movements, rather than investment based on an understanding of fundamental value.³³

Annex 2: The prevalence, effects and causes of short-termism *continued*

- Research by the Bank of England finds short-termism – defined as “the tendency of agents in the financial intermediation chain to weight too heavily near-term outcomes at the expense of longer-term opportunities” – in the form of excessive discounting by investors, with cash flows five years ahead discounted at rates more appropriate for eight years hence; 10-year-ahead cash-flows valued as if 16 or more years ahead; and cash-flows more than 30 years ahead scarcely valued at all.³⁴ The Bank conjectures that investment short-termism may induce firms to distribute a sub-optimally high share of their revenues and profits to shareholders in the form of dividends, to meet their demands for near-term income streams, at the expense of retaining, or ploughing back, profits into the business to finance future growth opportunities. It finds substantially higher investment as a proportion of profits by private firms than publicly listed firms, and calculates that “the elimination of short-termism would ... result in a level of output around 20% higher than would otherwise be the case”.
- A comprehensive literature review by the Centre for International Finance and Regulation (CIFR) in Australia, supported by the Future Fund (Australia’s Sovereign Wealth Fund), summarises the costs of short-term investor behaviours as greater market inefficiency; excess volatility; procyclicality; less effective corporate monitoring; and less efficient intermediation due to additional costs.³⁵
- Research by Mercer found a strong tendency for active long-only managers to have higher turnover than they claim, resulting in high trading costs and a risk of misalignment between the client’s time horizon and the manager’s. Managers reported experiencing pressure from clients to demonstrate short-term outperformance against a benchmark.³⁶

Causes of short-termism

The principal causes of short-termism in equity markets highlighted in multiple academic and industry papers over many years include:

- Short-term investment processes and performance monitoring that are not aligned with clients’ (eg pension funds’) long-term objectives (eg liabilities) – eg quarterly monitoring of benchmark-relative performance, rather than a focus on performance metrics linked to long-term ‘real’ objectives, such as ‘inflation plus’; focus on short-term price and valuation rather than long-term cash flows
- Executive (company) remuneration linked to short-term performance targets
- Asset manager remuneration linked to short-term performance targets
- Insufficient stewardship/engagement by asset managers to encourage companies to focus on long-term performance (eg pressure for quarterly earnings guidance, failure to question management on long-term value drivers and strategy)
- Regulation that requires mark-to-market valuation of pension funds and a focus on short-term funding levels (the match between assets and liabilities)
- Competitive pressures towards short-term performance reporting by asset managers (eg for retail mutual funds).

Annex 3:

Consultation responses

The ILG prepared a consultation paper on long-term responsible and sustainable investment as part of this project. In addition to comments from ILG members, responses were received from:

- AP4, Sweden
- Australian Super, Australia
- British Telecom Pension Scheme, UK
- Commonwealth Bank Group Super, Australia
- Eumedion, Netherlands (represented by Aegon Asset Management, Ownership Capital and RobecoSAM)
- Lane Clark Peacock, UK
- Mercer Investment Consultants, UK
- State Plus Financial Services, Australia
- TKP Investments, Netherlands
- Unilever Pension Scheme, UK

We also held discussions with Towers Watson (now WillisTowersWatson).

We are very grateful to all those who contributed to the project.

References and notes

- ¹ While concentrating here on listed equity, we acknowledge that many of the concepts and approaches discussed here could equally apply in other asset classes – notably private equity, unlisted real estate, infrastructure and real assets. These may be addressed in future work.
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- ¹² See for example:
Friede, G., Busch, T. & Bassen, A. (2015). ESG and financial performance: aggregated evidence from more than 2000 empirical studies. *Journal of Sustainable Finance and Investment*. 5:4, 210–233. doi:10.1080/20430795.2015.1118917. Retrieved from <http://www.tandfonline.com/doi/pdf/10.1080/20430795.2015.1118917>
Clark, G., Feiner, A. & Viehs, M. (2015). *From the Stockholder to the Stakeholder*. University of Oxford/Arabesque Partners. Retrieved from http://www.arabesque.com/index.php?tt_down=51e2de00a30f88872897824d3e211b11
Deutsche Bank Climate Change Advisors. (2012). *Sustainable Investing – Establishing Long-Term Value and Performance*. Retrieved from https://www.dbadvisors.com/content/_media/Sustainable_Investing_2012.pdf
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Consolidating three years of leadership

The Investment Leaders Group (ILG) is three years old. Over that time we have taken a fresh look at some of the most interesting challenges and opportunities thrown up by investment. We'd like to share some of the highlights of this journey with you.

The group started by clarifying the purpose of its work in the 2014 report, *The Value of Responsible Investment*. This explored the ethical, financial and economic cases behind responsible investment, concluding that it is not only consistent with fiduciary responsibilities but, done well, can improve long-term returns while reducing systemic risks.

We then turned our attention to *fiduciary law*, particularly in the United States where pension fund trustees and beneficiaries have struggled to relate social and environmental issues to investment decisions.

A presentation was published to explain why these are legitimate concerns of fiduciaries. It was gratifying to see the US Department of Labor concur with this position in recent guidance.

Three areas were then selected for more work:

- **Investment impact.** While the financial performance of funds is readily accessible, their social and environmental impacts remain largely opaque to the public and the industry itself. To change that, we have developed a framework (*In search of impact*) to help investors measure and communicate their contribution to sustainable development.

- **Investment mandates.** In this report we identify the characteristics of mandates that encourage long-term, sustainable investment management. By adopting this guidance, investors strengthen their ability to make capital work in the long-term interest of beneficiaries and society.
- **Risk and opportunity.** While many investors recognise social and environmental risks in portfolios, they lack tools to integrate them into existing financial models. Climate change poses a clear and present risk (and opportunity) to investments and was therefore our starting point. Our report, *Feeling the heat*, guides the industry in assessing the impact of carbon-related regulation on asset profitability, while our research, *Unhedgeable Risk*, published in 2015, examines the effects of climate-related shifts in market sentiment on portfolio value.

It would not be an overstatement to say that if the proposals in these reports were implemented, the investment industry would evolve into a force for positive social and environmental impact in the world, a true partnership with our clients and beneficiaries.

This would be some accomplishment. We hope you will join us on this journey.



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