

Long Term Long Only Consultation Paper Responses – A Summary

There have been many column inches dedicated to how pension funds view risk and return, given the performance of public investment markets, the dynamics of using third party investment managers and the time horizons under consideration. However there is currently little practical guidance for Trustees considering the mechanics of long term investment management.

The Marathon Club's (The Club) consultation paper, launched in March 2006, was intended to stimulate debate from all parts of the investment industry and form consensus on the principles of long term, long only (LTLO) investing. Ultimately, the Club's objective is to provide practical guidance to trustees of pension funds, trusts, and foundations on what the components of a LTLO mandate might include.

The Club's consultation received tremendous interest from the institutional investment industry, third party commentators and specialist media. We have been pleased with the comprehensive and thoughtful responses received from a broad range of investment institutions in the UK and around the world, providing useful additional insights that enhance our guidance. Responses have been collated by the Secretary to the Marathon Club, Hewitt Associates.

This paper is designed to provide an informative summary of the responses received by the Marathon Club.

Highlights

The following key themes emerged from the responses:

- An explicit articulation of trustee beliefs is of critical importance and should be undertaken in conjunction with the fund's advisors and investment managers.
- Merely lengthening the term of the investment contract will not itself change short term behaviour, if the focus continues to be on quarterly performance
- Getting trustee governance structures right and ensuring appropriate trustee understanding is essential to the in-depth understanding of issues required for a long-term view.
- A greater focus must be placed on the development of a portfolio's investments within the review meeting. This should be based on factors other than short term share price

Expanded discussion of the responses

The responses to the LTLO paper's twenty one consultation questions have been organised into the following four broad areas:

- Trustee Beliefs and Fund Governance
- The LTLO mandate – Concept and Structure
- Investment Objectives and Alignment of Interests
- Manager Selection and the Ongoing Relationship

Trustee Beliefs and Fund Governance

Perhaps the area of greatest consensus was the emphasis placed on the articulation of trustee beliefs by the consultation paper. While recognising the effort that additional training would require, all respondents valued the critical role which an explicit articulation of beliefs plays in a LTLO mandate.

Some of the key points made were:

- The list contained within the consultation paper of areas around which trustees need to formulate beliefs is too long and specific
- There need to be more guidelines on the subject of budgeting for, setting and controlling risk exposure
- The current trustee governance model would have difficulty coping with an LTLO mandate due to insufficiency of expertise and resource
- Wide support for increased use of delegatory powers by trustees allowing the use of specialist expertise where required
- Change of governance structure to permit increased delegation of decision making to relevant experts to be encouraged. Trustee role to move towards supervising and managing of professional resources.

The LTLO mandate – Concept and Structure

The overall sentiment of the responses in this area was that the LTLO concept was a very positive and viable option for institutional mandates and that the consultation paper was successful in highlighting the key components of such a mandate.

Some of the key points made were:

- The relevance of defining a long term business cycle as the appropriate term for a long term mandate was questioned. Respondents suggested a need for greater flexibility of term, to allow for the realisation of returns or member specific cycles.

- Respondents felt that an LTLO mandate should explicitly permit the investment manager to hold cash if suitable investment opportunities do not exist or encompass a measure of asset allocation in-line with achieving absolute returns
- The need for a suitable LTLO manager to have a lengthy track record was questioned by some. It was pointed out that long track records can mask changes in personnel and evolution of process.
- The need for concentrated portfolios and low turnover was questioned by some investment managers.
- The concept of ‘Universal Ownership’ received a mixed response. The difficulty in pursuing a consensus interest for all ultimate beneficiaries was raised.
- There are some very real barriers to the success of long term mandates such as the short term pressures that can arise from accounting standards (FRS17) and increased regulation.
- Some concern was expressed that a large move into LTLO mandates could reduce market liquidity
- Questions were also raised by respondents about whether the available skills for LTLO mandates were available within the investment management industry

Investment Objectives and Alignment of Interests

Overall, there was strong agreement on the key objectives of LTLO investing such as efficient allocation and preservation of capital and risk protection.

Some of the key points made were:

- Absolute return benchmarks are still not considered a natural choice for equity only mandates. Respondents felt it therefore becomes very difficult to monitor and evaluate the performance of equity portfolios without a traditional index benchmark
- Multiple criteria need to be used to evaluate this type of mandate – use of balanced scorecards could be appropriate
- Very few respondents believed that performance related fees had a positive impact on manager behaviour. Some concern was expressed about the possibility that performance-related fees encourage an investment manager to take more risk due to asymmetry of fee structure
- Co-investment was more popular than performance related fees as a way of aligning interests. However, it was noted that the investment manager’s personal investment objectives might be quite different to those of the fund, making meaningful co-investment difficult
- Deferred bonus fees were commonly viewed as a viable way of aligning interests

Manager Selection and the Ongoing Relationship

There was broad consensus that the manager selection process would need to change to allow a deeper mutual understanding of investment objectives and philosophies. However it was recognised that this would place additional pressure on trustees in allocating more time to the selection process and an increased requirement on trustee understanding.

The large majority of respondents were supportive of a framework for regular manager review meetings where trustees and consultants set the agenda and focus on the underlying characteristics of the portfolio, instead of on quarterly performance.

Some of the key points made were:

- There is currently a lack of managers with an LTLO mindset
- A move to in-house management would prove difficult owing to lack of available talent and resource
- Moreover, in-house management may not automatically lead to improved trustee/manager communication
- Manager behaviour is influenced by how performance is currently monitored
- Trustee governance and resourcing represents a major challenge for LTLO
- Manager review meetings should focus on adherence to process and the underlying characteristics of the portfolio. Emphasis should be placed on the quality and comprehensiveness of the discussion, with a clear agenda for meetings set in advance by trustees and consultants
- Quarterly review meetings can form part of LTLO so long as the focus is not placed on quarterly performance. Other respondents favoured six-monthly or annual review meetings
- Circumstances leading to the termination of a mandate should be clearly articulated

Conclusions and Key Messages

- An explicit articulation of trustee beliefs is of critical importance to a successful LTLO mandate
- Market short-termism has been compounded by structural and regulatory factors. These continue to represent very real barriers to change.
- Consensus is building around a need for change, but this must encompass all parties in the investment chain (trustee, consultant, investment manager).
- Merely lengthening the term of the investment contract will not itself change short term behaviour. Market behaviour is heavily influenced by current reporting and

performance review processes. LTLO is about a change in mindset, rather than compliance with prescriptive rules.

- The ability to measure performance and remunerate managers in a way that comprehensively aligns interests under LTLO mandates may require multiple performance criteria and flexibility of reward structure
- The industry doesn't need more regulation, however, getting trustee governance structures right and ensuring that trustee understanding is adequate is essential to the in-depth understanding of issues required for a long-term view.
- However, Trustees need to consider best use of their time and this may include an increase in delegatory powers by trustees that makes optimal use of professional resource

Next steps

The Marathon Club has welcomed the constructive suggestions which have been received and is excited at the prospect of producing a final guidance note for release in November 2006 that helps the industry as a whole move towards overcoming the barriers to short-term investment.