BRIEFING
LONG-TERM INVESTING

Long-term investing: it's up to the pension board

A practical framework for pension fund trustees looking to implement long-term investment approaches

MARCEL JEUCKEN AND ALFRED SLAGER

Pension funds are increasingly trying to embed long-term investing choices within their portfolios. Many publications focus on the rationale for long-term investing; however, it remains unclear what long-term investing actually is, what sets it apart from the current way of investing, and how it should add value. The purpose of this article is to provide a practical framework for pension fund trustees aiming to bolster and implement long term investing. In doing so, we choose the trustee's perspective, build on different existing selection and monitoring frameworks, and argue that pension boards have more instruments at hand to implement long-term investing.

Entering the mainstream

Reading IPE and following conferences diligently, one could get the impression that impact investing and long-term investing finally broke through in 2019. Pension funds worked hard on a taxonomy to provide more transparency; trustees reaffirmed their commitment to increase allocations to these strategies. Board members and CIOs joined international platforms to propagate the view that the financial system is broken – just look at failing monetary policies – but also that it is not beyond repair if we as asset owners award and steward mandates that have a truly long-term horizon, allowing portfolio managers to pursue other goals than simply replicating or beating benchmarks.

Various pension funds are implementing long-term portfolios with novel approaches. In a recent paper by the Sustainable Pension Investments Lab[*] we explored a case study to apply long-term investing frameworks successfully, the strategic equity portfolio run by SPF, the Dutch Railways Pension Fund. The fund has a belief and approach that long-term investing is concerned with harvesting long-term risk-and-return sources in a way that investments are not chosen and held with the expectation that they can be used to achieve an above-average return in the short term, but with the expectation that this will be the case in the long term. To that end, the investment style stimulates the long-term behaviour of the entities in which it invests.

A deliberate choice

In other words, long-term investing is a deliberate choice. Investing in an index fund, even holding it for 30 years, is not a long-term investing strategy unless the pension fund actively stimulates the long-term behaviour of all the underlying companies. This is a tall order. Therefore, long-term investing strategies tend to be concentrated. On a similar note, investing in assets which by design have a horizon over many years does not constitute a long-term investing strategy per se. Here too, the decisive question is whether or not the pension fund actively stimulates long-term behaviour of the investee entities and formulates this as part of the investment approach.

The toolbox for actively stimulating long-term behaviour is provided by ESG (environmental, social and governance) risks and opportunities analysis, and outcomes related to the UN Sustainable Development Goals (SDGs). This means connecting the impact of changes and performance of the real world on the investment portfolio to the impact of the investment portfolio and stewardship activities in reality.

The rationale for asset owners to increase long-term investing is compelling:

- First, it helps to focus on the long-term cash flows that matter to the valuation of the company, especially in combination with ESG risks and SDG outcomes.
- Second, long-term investing supports investments that might be unattractive in the short term but nevertheless valuable.
- Third, monitoring and selection costs drop: the likelihood that mandates will be switched decreases, avoiding transaction costs, while the investment manager can spend more time monitoring the investment in depth due to the longer horizon.
- Fourth, the use of ESG and SDG

Steps and adjustments needed for long-term investing

Step	Adjustment
Policy	1. Develop a shared definition and vision on long-term investing that is agreed by the whole board, and document it in the investment beliefs. In case some of the board members have doubts, it is important to take time to get strong support for the strategic choice.
	2. Ensure that new board members subscribe to the principles, investment beliefs and approach concerning long-term investing before they are appointed, and not afterwards.
	3. Discuss the consequences that the long-term investment beliefs have for the implementation of the investment policy.
Governance	4. Develop a 'pre-mortem' by identifying potential problems and taking mitigating measures beforehand. The board should determine at the start of the investment when the investment or mandate may come 'under pressure'. Is the choice strongly propagated by a few members or the entire board? What if there were a completely different board in five years, would this investment still be seen as sensible?
	5. Develop a 'board check' for long-term investing, to determine if the board members are capable in long-term investing. If this board check does not see the desired results, the board members should first think it through more, or accept that they will not be doing it.
Selection	6. Ensure that the manager fully utilises the long-term horizon. Challenge the manager how they are planning to make optimal use of this, as well as which ESG themes are addressed within this horizon.
Monitoring	7. Be clear about the role of the benchmark. Is this the starting point for a discussion, is it the main investment objective, or does the pension fund see a different role for it?
	8. Choose risk measures that are relevant to the long-term horizon of the mandate. For example, do the companies in the portfolio have stable outlooks, what about increasing debt ratios? Indicate what quantitative risk measures actually entail. Is there a function for the ex-post tracking error?
	9. Design reports so that as a board you discuss the right topics. Start with the qualitative monitoring criteria for the portfolio, and not the investment returns of the previous month. Show the intended horizon for the strategy in the reports by default.
Evaluation	10. Make a clear distinction between monitoring and evaluation, and act accordingly.

Source: Authors

Marcel Jeucken and Alfred Slager

data in the investment decision can reduce the risks of the investment, helping investors earn the expected risk premiums.

Overcoming hurdles

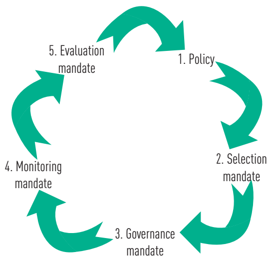
However, though examples exist, they are not followed through. Asset owners talk about the need but find it difficult in practice to implement, these strategies. Admittedly, setting up a long-term investing strategy requires work, but apparently more hurdles must be at play.

In a project in the Netherlands, the platform for Sustainable Pension Investments (SPIL) engaged with asset owners to identify these hurdles in a pragmatic way. Using the investment policy process cycle that many pension fund boards are familiar with (see figure), SPIL discussed with trustees what hurdles they experienced and how to resolve them.

A surprising finding was that trustees are sympathetic to long-term investing, but that many initiatives seem to falter in the selection and monitoring process. One of the reasons suggested was that important assumptions were seldom made explicit. If a pension fund mentions in its beliefs that it is a long-term investor, what does it mean? Is it just a remark about the horizon, a vision on financial markets, or a vision about the difference between price and value and the role of ESG? If a board is not clear about these beliefs and assumptions from the start and what it means for the selection and monitoring process, the investment staff or asset manager will revert to its standard set of choices and instruments.

Another finding was that boards, especially new board members but also external members of investment committees, can find long-term investing strategies bewildering. In their formal training to become a trustee, it was probably never part of the standard toolkit. (Where to fit it? Active or passive; value or growth?) Without a proper grounding in, or experience of, what to expect, every performance deviation in the monitoring process turns into an evaluation, costing governance budget and decreasing support for the strategy.

Stylised investment policy process cycle for pension funds



Source: Dutch Central Bank (DNB)

A third finding, relevant for the Dutch context, was that although the regulator is considered to be demanding and strict, it does not really impose hurdles; the pension fund boards have sufficient freedom to implement these strategies, provided they know what they are getting themselves into.

Overall, long-term investing strategies can be implemented within the regular investment cycle of pension funds, and boards can make this a success by just making minor adjustments to their process. The table suggests a number of changes where, unsurprisingly, the focus is on the board's role. Successful long-term investing is within the boards' reach, not the politics or regulators.

* www.spil.org. The paper is available at SSRN: https://ssrn.com/abstract=3494956 or http://dx.doi.org/10.2139/ssrn.3494956

Alfred Slager is professor pension fund management at TIAS Business School, Tilburg University and trustee at the Dutch pension fund for general practitioners (SPH). Marcel Jeucken is founder and managing director of SustFin