Being a long term Investor

"Someone's sitting in the shade today because someone planted a tree a long time ago."

Warren Buffet

Introduction

The Environment Agency Pension Fund (EAPF) is an open, active pension fund with liabilities into the next century. Young new members coming into the Fund may not retire until 2065, and will be drawing a pension for many years after that. This means that we genuinely have a long term perspective on investment – for us successful investments are ones that deliver over decades rather than weeks.

This long term perspective clearly is closely linked to our desire to invest responsibly – many environmental, social and governance issues will affect investment returns, but may take many years for their financial impacts to be visible. The challenge for us is to implement a long term investment approach in practice, particularly when volatile and unpredictable markets can result in sudden short term underperformance and create pressures to act. In addition, we outsource our investment management to a range of managers and so we need them to act as long term investors on our behalf. This paper outlines how we have sought to overcome these challenges and describes our approach to being a long term investor.

Evolving our approach

Our approach to investing our assets and appointing managers has, for many years, included key aspects of long term investment. The following have been the main elements of our approach.

- We seek to appoint managers that take a long term view based on the fundamentals of companies – "investors" rather than "traders" – our selection criteria focus on investment process and the identification of long term value. We also look for stable organisations with similar values.
- We explicitly assess prospective managers' stewardship capabilities – their involvement in voting and engaging with the companies they invest in – as part of our fund manager selection process.
- We are focused on long term performance, and aim not to be too concerned about short term underperformance either when selecting managers or when monitoring them.
- Once appointed, we monitor and engage with managers on their stewardship activities, strategic vision and fundamental evaluation of prospective investments, and are more concerned about weaknesses in these areas than we are about a quarter of poor performance.

All our managers reflect and incorporate these elements to a greater or lesser extent. A good example of a fund manager that puts a long term view at the heart of their investment approach is the recently established Dutch specialist, Ownership Capital, profiled in the box below.

Ownership Capital: Long Horizon Investing in practice

Ownership Capital, which launched in 2013, began its "long-horizon investing" equity strategy in 2009 inside leading Dutch pension fund manager PGGM. Convinced that high-quality companies with the best corporate citizenship will also be the most profitable over the long term and utilizing new, long-range analytical models, its strategy explicitly focused not just on the measurable financial prospects of a business, but also, crucially, on the often-overlooked environmental, social and governance risks of the companies and industries in which it operated. Furthermore, the team actively engaged with each company it invested in to stimulate corporate leadership in dealing with long-range but very financially relevant risks such as Climate Change, leadership succession, and stakeholder excellence.

This engagement approach, which they coined "Ownership Investing", led companies to dramatically increase their focus on long-term risks, so not only improving energy efficiency for example, but also directing innovation to ensure products and supply chains became genuinely sustainable. While such transformations should be measured in decades, early results have shown that this sustainable focus dramatically improves the financial performance of a company through substantial energy and human resource efficiency enhancements. And while the strategy has not yet reached its own 10 year milestone, the results to date have shown that a focus on long-term value creation, perhaps unsurprisingly, also generates financial returns well in excess of the "average" of the index.

Developing investment mandates

When developing mandates we consider carefully how the mandate can be best developed to meet our long term needs. This includes considering carefully the benchmark; the risk targets and control measures; and the fee and incentive structures.

Benchmarks can have a disproportion impact on managers, and can have issues of their own (e.g. concentration on a few large stocks) although the issue is more often with managers who focus too much on the benchmark. For us, a key test is whether the benchmark properly reflects an investable alternative, reflecting what we want from the mandate. We use alternative or composite benchmarks if they offer a better fit, and also use secondary benchmarks to reduce the focus on a single measure.

Risk control measures are particularly significant – we reduce the focus on risk against the benchmark ("relative risk", or sometimes - incorrectly for long term, active mandates – referred to as "tracking error"). Instead we focus more on measures of absolute risk (against cash or liabilities), as well as looking for proxies for long term risk such as carbon exposure and governance quality. Building on this we prefer to have relatively concentrated portfolios, and avoid active mandates where stocks are held merely to reduce risk against the benchmark.

Fee structures are obviously significant. Much has been made of performance fees as a way of aligning managers and investors. However we are generally cautious of performance fees – they

are complex to structure well; can increase costs; and can affect behaviour. Of particular concern to the long term investor is that they can incentivise short term action, such as taking speculative bets. Where performance fees are used, we try to structure them carefully, with attention on the benchmark to ensure it is challenging and appropriate; a significantly reduced base fee; full use of high watermarks and rebates; and with actual payments made over longer term times frames (at least three years) to ensure a long term approach. Simpler flat fee structures may work as well – for most managers keeping clients happy long term is a lot easier than winning new clients.

Buy and Maintain bonds: taking a long term approach

Most bond portfolios are managed against an index, which means the manager has one eye on the index allocation, and is constantly managing their portfolio against the benchmark, rather than considering fundamental risks in their own right. Yet bond indices are often flawed - the more a company borrows the worst its credit is, but the greater its weight in the index. From our perspective, the index is of limited fundamental relevance. To address this, we created a buy and maintain bond mandate with Legal and General. The mandate is not formally benchmarked; instead the aim is to build a portfolio of good value bonds with a view to hold them to maturity. The managers can build up a wide range of names without focusing on the larger issuers. Similarly sector allocations can be built up to be properly balanced, rather than follow the peculiarities of the index's allocation, which tends to have high weighting to certain sectors. Although bonds are bought with a view to hold to maturity, they can be sold e.g. if credit risks are increasing, but turnover and costs are much lower than conventional active bond mandate.

Talking to the manager about the mandate there is a real difference in approach, with a real focus on long term value rather than worrying about the vagaries of the market or what other investors are doing. For example, the manager is likely to be cautious about buying a poor credit that is looking oversold, while a more active manager may see some short term potential.

The Kay review of UK equity markets and long-term decision making

Professor Kay's review of the UK equity market in 2012 sought to ask how well equity markets are achieving their core purposes: to enhance the performance of UK companies and to enable savers to benefit from this performance through owning shares in these businesses. The Review found that short-termism is a significant problem, leading to both under-investment and hyperactive behaviour by executives to the detriment of long term value generation.

The report found that this short-termism is caused by a decline in trust and by a misalignment of incentives and that fund managers have a key role. While some are "investors" looking at the fundamental value of the company, others are "traders" acting on expectations of short term price movements and contributing to the problem. Furthermore, the appointment and monitoring of fund managers is too often based on considerations of short-term relative performance, which can encourage the "trader" over the" investor".

To address this gap, Kay review called for a new approach for investing in the UK, with a focus on "stewardship", seeking long term value creation along the investment chain, and in particular for asset managers to contribute more to the performance of British business (and in consequence to overall returns to their savers) through greater involvement with the companies in which they invest. These values were embedded in a new "Stewardship Code" for asset managers and investors.

Responding to the Stewardship debate

We are very supportive of the Kay review, and we have encouraged the use of the Stewardship Code since inception. When we used the Kay review to review our own activities, we felt that we already had adopted and reflected many of the values and recommendations, in our actions above. However, as we considered the Review further we realised there was more we could do, particularly to share and communicate our values and thinking.

One finding was that, although we had clear views on our high level investment beliefs and principles, they were not formally recorded, and there would be value in documenting and communicating clearly our high level investment principles (listed at the end of the report).

Very much in the spirit of Kay, the first of these is simply to recognise that we are a long term investor – a simple statement but one which has powerful consequences.

We have found documenting our investment principles in this way very useful. Beliefs and principles can be written in non technical language and help trustees and members to understand what we are trying to achieve. Although they are so embedded in our thinking we do not need to refer to them explicitly all the time, they can be useful to help clarify the most appropriate approach when there is a debate about a particular issue.

Rethinking Manager Relationships

The Kay review also prompted us to consider whether the mandates we had with our managers were really long term, and whether we were effective in supporting our managers in taking a long term view of investments and stewardship at companies. Despite our long term approach, other considerations mean we could be putting short term pressures on managers inadvertently and not always appearing as a long term investor. For example, regulations mean we have to be able to terminate our mandates with no notice. Similarly we are required to get brief monthly and full quarterly reporting from our managers.

Discussions with managers revealed that they were indeed more aware of the terms of their contract rather than the broader thinking of our long term approach. We also found that managers can be very sensitive to language, for example often over-interpreting requests as implicit criticism. As a result they often felt under short term pressure, and were perhaps not always able to take the long term view. The reality was that they were not particularly aware, not just of our policies, but also of practically just how long term we are. For example, in our modelling of fundamental returns and risks we look out fifteen years and more. Another example is that changing managers is a time consuming exercise we undertake with great reluctance, and we would rather work with managers to address problems than change a manager abruptly - our turnover of managers is low, and change is more often a result of changes at managers than performance.

We considered how to address this mismatch by revisiting our contracts with managers and other documentation, and identified three key areas for action:

1. An updated investment Management agreement – the formal contract with managers
2. A new client-manager "Covenant" – to clarify expectations of each other
3. Revising reporting and communication – to reflect and reinforce long term thinking.

Reworking the Investment Management Agreement (IMA)

Our new standard IMA, which we expect managers to broadly agree to, is based on the model mandate by the ICGN (International Corporate Governance Network), but seeks to go a little further in key areas:

- The "fiduciary" nature of the relationship is made clearer, through deconstructing the principle of fiduciary duty into its key components, notably a requirement to act in our best interest.
- We have placed greater importance on key man risks and the need for orderly transitions of personnel, to highlight the importance we place on this issue.
- To protect managers, we introduced a modest notice period for the first time (1 month - the most we are allowed under LGPS regulations).
- We have also requested greater transparency on pay and incentives structures (although this is an area which will take a while to change).

Note that we are constrained from having a long notice period. If this were not the case, we would consider a somewhat longer notice period, but we are reluctant to have a long fixed term contract as this creates more problems than it solves (e.g. defining grounds for early termination). We feel working on the client manager relationship as outlined below is a more effective option.

Establishing a Client-Manager Covenant

The covenant is the core of the new approach and lays our expectations of managers and what they should expect of us too. It is not legally binding, but intended to give greater clarity to the practical workings of our relationship – documenting explicitly some of the unwritten assumptions that otherwise can lead to misunderstanding. It emphasises the need for communication. It directly addresses the key issue of why we might terminate the mandate: emphasising that "style drift" or team instability is of greater concern to us than short term underperformance. It requires us to provide feedback to the manager and to keep them informed of broader changes in the Fund.

It also includes a clear commitment to work to repair mandates if possible rather than retender them, something we have done with two managers in recent years (changing the benchmark with one, ensuring the other stayed focused on their core strengths.)

Reporting to a long term investor

Reporting is the visible interface of the fund manager – client relationship. If reporting is focused on short term measures, then inevitably it will tend to make the relationship more short term. It is possible to make a case for less frequent reporting – perhaps only annually – to give more of a long term perspective. However, given the fees paid to investment managers and the financial risks involved, we are reluctant to move to solely annual reporting supports and reflects the long term investment process, short term noise.

So instead we are modifying our reporting to reflect long term concerns. Rather than basic monthly reporting and extensive quarterly reporting, we are moving to ad-hoc, core quarterly and extensive annual reporting. Ad-hoc reporting is primarily intended to cover significant events, such as team changes.

Quarterly reporting remains but is being somewhat simplified and focused, while increased emphasis is being given to a detailed annual report. The context of reporting has been reconsidered to ensure it all is relevant to long term understanding, so there is:

- Greater attention on a narrative reporting, particularly on changes and activity – we are really after a window into the manager's thought processes.
- Disclosure of real business metrics (sales, cash flows, profits etc), typically aggregated across portfolio companies, so we can understand how the businesses in a portfolio are really doing.
- Less emphasis on endless attribution analysis to dissect what the market is focused on.
- Tracking of progress towards agreed stewardship objectives, including engagement and voting activities, focusing on key issues, results and continuing dialogue.
- Disclosure of long term ESG metrics such as annual carbon emissions.
- Again annually, a summary overview of the companies in the portfolio, focusing on long term matters such as strategy and governance.

Conclusions

As a long term investor, we recognise the important of ensuring that our long term values are implemented throughout the investment chain. Although consistently ensuring that this happens is a challenge we believe it is something all investors can embrace. The checklist below summarises the key actions we have taken and other investors may want to consider.

"As in all human relationships, communication is the key to successful long term investment."

Mark Mansley, Chief Investment Officer, EAPF

Long term investing: A checklist for asset owners

☐ Develop and communicate your investments beliefs and principles

☐ Integrate these beliefs into your manager selection criteria, especially when looking at investment process and organisational qualities.

☐ Ensure you explicitly evaluate managers on their stewardship and governance capabilities

☐ Pay little attention to short term performance "past performance is no guide to future performance" – focus on the process; if you must consider performance, look long term.

☐ Ensure your contractual relationships don't create inadvertent short term pressures

☐ Ensure reporting is relevant to a long term mandate and to your needs.

☐ Monitor your managers – but not by looking at short term market performance: look for idea generation, strategic insight, team renewal, and real indicators of business performance of the underlying companies. Think like a manager of an industrial holding business!

☐ Communicate with your managers regularly, particularly sharing your expectations of them, and your own pressures and concerns – consider a covenant or similar.

Our Investment Principles

1. We are long term investors: we invest in productive assets that contribute to economic activity, such as equities, bonds and real assets, and thereby aim to earn a sustainable and sufficient return on our investments.
2. We are responsible investors: we believe that we will overall generate better returns by investing in companies and assets that contribute to the long term sustainable success of society.
3. We adopt best practice fund governance with appropriate prioritisation, decision making at the right level, and internal accountability.
4. We make our decisions based on extensive expertise: trained and insightful committee members; experienced and professional officers; and high quality, knowledgeable advisors.
5. We take an evidence and research based approach to investment: continually learning and reappraising from academic research, investment professionals, and our peers, and seek continual development in our understanding of investment.
6. We are prepared to be innovative and demonstrate thought leadership in investment, within the requirement of prudence and our fiduciary duty.
7. We will make our investments work as hard as possible to meet our objectives: we recognise the importance of getting the right asset allocation, but also the value of getting the right structure and managers within asset classes. While we take account of market and economic levels in our decision making, we avoid making decisions on purely a short term basis.
8. We will be comprehensive in our consideration of risk, and efficient in where we take risk: we will base our assessment of risk on our liabilities and contributions; consider financial and non financial risk as appropriate; diversify risk as much as possible, but also recognise the limits of that diversification – as long term investors we accept that our investment success depends substantially on the sustainable growth of the economy.
9. We will exercise responsible stewardship of the assets we hold, and act as a responsible voice in the broader investment community.
10. We will seek the most cost-effective solutions to achieving our objectives and implementing these principles: we recognise the impact of costs on the Fund, but we are prepared to pay for active management and other services when we believe that the costs incurred are likely to be justified by the benefits.
11. We believe in the importance of being transparent and accountable, to ensure correct decisions are taken and to minimise risk. This applies both in our own operations, those we work with, and our investments
12. We will collaborate with others whenever possible, to share ideas and best practice; to improve effectiveness and to minimise costs.