Marathon Club

Guidance Note for Long-Term Investing

Spring 2007

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Foreword

The Marathon Club was formed to stimulate institutional funds to be more long term in their thinking and actions, and to place a greater emphasis on being responsible and active owners.

A fundamental issue arising from earlier research and discussions between Club members is how best to overcome the apparent barriers to long term investing, particularly in an environment where funds face deficits and funding problems.

The Marathon Club has received a wide range of responses to the consultation paper it issued in March 2006. This dialogue has greatly assisted us in developing the guidance contained in this document. This is not put forward as a simple solution to the problem nor as a common approach for all funds. However, it is clear that a successful approach to long term investing rests primarily on the mindset of trustees and their beliefs, and on how the investment process is structured, implemented and managed. There is also a heavy responsibility placed on those who advise funds and on those who manage the investments to deliver long term investing.

The Marathon Club plans to research in more depth some of the components expressed in this guidance. In the meantime, I hope you find this document helpful in developing your investment approach and strategy.

Peter Scales, Chairman

Marathon Club

Spring 2007

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Executive Summary

This note seeks to provide practical guidance to trustees and their advisers on behaviour consistent with a long-term approach to investing. In the **Introduction** we note the problems and causes of short-termism identified by Myners and others. We explain what a long-term approach to investing means – an emphasis on capital protection and return over one or more business cycles of at least five years, underpinned by deep fundamental research including understanding long term threats and opportunities – and why pension funds should approach investment in this way. We also identify **6 key components** of a long-term mandate.

We explain firstly why trustees' **investment beliefs** are a fundamental component, which affect all others. We propose that trustees' beliefs should be formally recorded as a standing guide, which should incorporate the trustees' attitude to risk, preferred sources of return, and views on investment styles, governance and ethical issues. We give an example of a beliefs document in Appendix A.

The Marathon Club recommends that clear **objectives** for risk and return should be set, based on the trustees' beliefs and long-term goals, and we list some suggestions. Objectives should be communicated clearly to advisers and investment managers.

Appropriate **selection** of investment managers depends upon determining how each candidate's approach best fits with the trustees' long-term investment beliefs and objectives, together with the establishment of clear mandate parameters. The Marathon Club recommends that trustees ensure that sufficient time is taken to select the right manager. We highlight the advantages of site visits to gain in-depth knowledge of a manager's philosophy and culture. In Appendix B, we set out the likely attributes of a long-term investment manager.

We believe that **alignment** of trustee and manager objectives for the long-term is best achieved through individual managers owning a stake in their business and through the manager's co-investment. We support the wider use of appropriately structured performance fees.

In building and managing a long-term **relationship** between trustee and manager, the Marathon Club places greater emphasis on the content, rather than the frequency, of review meetings. The emphasis of periodic reviews should be on testing the continuity of or changes to philosophy, process, systems, people and internal compensation, and why the manager owns the stocks he does, rather than on quarterly performance. We give examples of possible reports in Appendix C.

Implementation of these recommendations requires strong **governance** and leadership by the trustees, to control strategy and objectives consistent with their beliefs and to withstand the short-term ups and downs of the wider investment market which long-term investing necessarily entails. Trustees therefore need to communicate their beliefs, objectives and strategy clearly and should ensure transparency in implementing strategy and in monitoring outcomes.

The **Way Forward** requires trustees and advisers to work together to implement these recommendations and to develop a long-term approach appropriate to each set of trustees' circumstances.

Marathon Club - Guidance Note for Long-Term Investing

"We have a large pool of long-term capital, but do we invest it with a sufficiently long-term view?"

Paul Myners, Review of Institutional Investment, 2000

Introduction

Paul Myners' remarks echo a concern that is shared by many observers within and without the global investment industry. An obsession with short-term outcomes can result in investment choices which may damage or thwart the long-term development of the wider economy, a healthy corporate sector and the financial performance of investment portfolios.

The corporate sector is continually being influenced by the need to satisfy analysts' quarterly earnings expectations. Moreover, active fund managers, when selecting potential investments for their portfolios, are keenly aware that their clients – not least the pension funds of the companies that are being evaluated in this short-term manner – are assessing their performance on a quarterly basis. This obsession with short-term performance measurement is deep-rooted in the investment system and is reflected in a fixation with quarterly earnings guidance, deviations from consensus earnings forecasts, and a focus on a narrow set of performance statistics. The danger, to both investors and the companies in which they invest, is that pursuit of such short term goals may jeopardise long term growth opportunities.

These obstacles to long-term investment – focus on quarterly performance, over-use of stock market indices, and measurement of long term liabilities on a short term basis – have been well documented in various studies. Recognising this, some commentators have recently advocated that companies should give less frequent earnings guidance and shift focus towards longer-term indicators of the health of a business, while investors' attitudes should also change to take a longer term view.

While the need for a change in investors' behaviour has been recognised, the Marathon Club has seen little in the way of proposals as to how it might be accomplished. This guide is intended to help fill that gap - to inform institutional investors and their investment managers of the key elements of long-term investment and to provide advice on successful implementation of a long-term approach. This guidance has been prepared primarily for those people directly involved in making decisions on how the assets of pension funds, charities and endowments are invested. We refer to these decision makers collectively as "trustees".

Why invest long-term?

Generally pension funds and endowments must meet their obligations to members and beneficiaries over a long period. Even the most mature pension fund will likely have expected future liabilities which span more than 30 years. The investment objectives of trustees for the assets invested to fulfil their long-term obligations should recognise and complement this. Broadly speaking, trustees can seek to make money in two different ways: they can endeavour to take advantage of short-term opportunities, effectively to "win" against other investors, or they can seek to nurture genuine economic growth in which they can participate. In the first instance, both winners and losers will emerge as a result of market participants trading against each other. In the second, trustees will be winners if they allocate capital efficiently to businesses within the economy.

Peter Drucker summarised the case for long-term management as follows:

"*…by definition, pensions are long-term. Pension fund management therefore requires long-term strategies for true performance. It is an axiom proven countless times that a series of short-term tactics, no matter how brilliant, will never add up to a successful long-term strategy*".

Peter F. Drucker, The Pension Fund Revolution

Any investment represents an interest in the ability of a business to generate cash flow. This cash flow is ultimately the source of return to investors, in the form of interest, dividends or capital gain. Long term investors are concerned with not only the current return generated by a business but also the capital it must invest to survive, grow and meet future threats.

The contribution of income generation and reinvestment to the total return from equity and bond markets is often overlooked. A study by Brandes Partners shows that, over rolling 20 year periods from 1926-2003, the income component averaged over 60% of total return for UK and US equities.

Recognising the importance of income generation, the essence of a long-term approach should be to seek investments in businesses that have strong earnings potential. To protect against loss of capital, it is important to analyse these businesses carefully to be satisfied that returns are sustainable over a long period of time. Success with this approach requires a deep understanding of the business, its strengths and weaknesses, its capital requirements and risks. Above all, trustees will want to avoid the misallocation of capital which commonly arises from market bubbles.

The Marathon Club defines long-term investment as a fundamental, research-oriented investment approach that assesses all risks to the business and which has a focused discipline of seeking positive returns over the long-term business cycle.

The important elements of this definition are:

- an emphasis on protecting capital and seeking a positive real return over a business cycle, which is typically five years or more;
- thorough research around the fundamentals of a company including the impact of the wider economy, industry structure and trends, quality of management and competitive strength;

- a proper assessment of all risks, including threats due to the competitive environment, the factors of supply and production, labour, technology, regulation, political and economic stability, governance, environmental, social and reputation costs.

The Marathon Club recognises that the elements of this approach are neither new nor unique. It does believe however that true long-term investment will likely be resource intensive and require particular care in the selection and monitoring of investment managers to ensure that they have the skill, depth of knowledge, experience and, most importantly, mind-set required to really understand the long-term prospects and risks of different business sectors.

The long-term approach of allocating capital based on a fundamental understanding of a business is applicable to a wide range of asset classes that are suitable for trustees.

This financial perspective is consistent with a broader view of the responsibilities of trustees as the ultimate owners of the assets they hold – in particular the equity shares of limited companies, and physical assets, such as property, which they may hold directly or indirectly. One of the central tenets of this guidance – that corporate executives respond to the signals sent by investment managers, who in turn respond to the incentives and boundaries set by the primary investors – applies to both financial and what may seem, at least at first sight, to be non-financial considerations. While the Myners Report is primarily concerned with the institutional aspects of investment, it is inherent in its thinking that the decisions taken by trustees - or in some instances the decisions they do not take – are influential in defining the capital marketplace, and ultimately the shape of the broader economy.

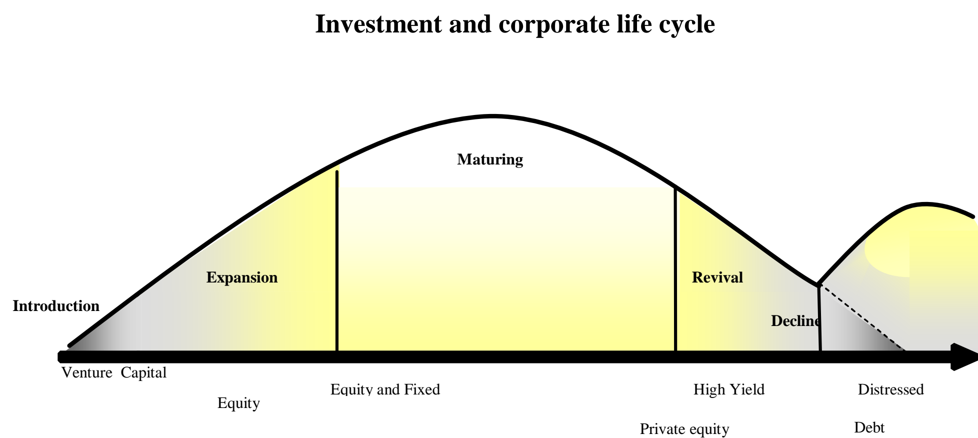
This guidance note is not intended to make a case for a particular social or political agenda, but the concept of 'socially responsible investment' is relevant. In the short-run promoting a certain ethical code, making certain environmentally-sensitive investments, may be viewed as incurring inadequately remunerated costs. But in the long-run such issues impact the firm's licence to operate and/or demand for its goods and services, so what appears as a cost in the short-run can produce genuine shareholder value in the longer-term, given the change in the commercial environment that has been created. Accordingly trustees need to weigh narrow short-term sources of advantage against the long-term impact of their decisions, conscious or unconscious. In this context decisions include broad investment allocation, the holding of individual assets and the exercise of ownership rights through voting policies, not just the timing of buying and selling. Trustees need to ensure that their ownership rights are exercised by investment managers with long-term benefits in mind.

Trustees can allocate capital to businesses within the economy at different stages of their life cycle - introduction, expansion, maturity, revival or decline. In each stage, businesses offer various forms of participation in their economic growth in which trustees can participate, as exemplified below.

- Venture capital investment in companies at early stages of their formation;
- Equity and fixed income investment in companies during their growth and maturity phases;
- High yield fixed income investment, typically in the late maturity phase;

Distressed debt and private equity in companies that are in decline or recovery.

Investment and corporate life cycle



There is a strong rationale for a disciplined long-term approach to investment across a wide range of asset classes, in recognition of the long-term nature of funds' obligations.

Is long-term investing appropriate for all pension funds?

Is a long-term approach only suited to pension funds which are well funded and supported by a financially strong sponsor? The implication of this question is that funds which are not well funded and which have weak sponsors could not adopt the mindset of a long-term investor, because they cannot accept the short-term volatility in asset values that may arise from a long-term strategy.

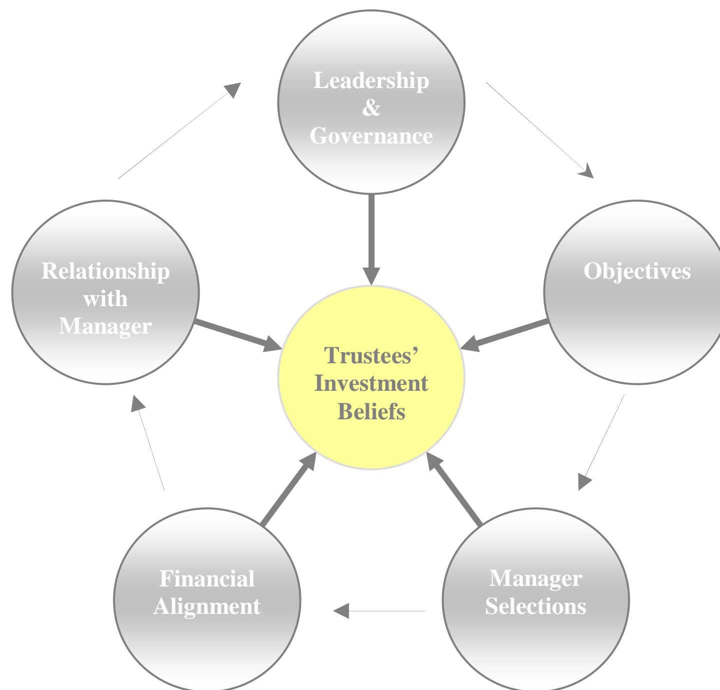
Clearly there is a link between the trustees, the sponsor and the regulator in the environment in which pension funds are managed. The financial position and regulatory requirements of individual funds or their sponsors will influence the assessment of risk, which impacts upon trustees' choice of asset classes, asset allocation and management of liabilities. However, these considerations should not detract from the need for long-term investment thinking within each asset class.

The Marathon Club considers that the issue trustees need to consider when deciding whether or not to employ a long-term approach to each asset class is their time horizon and not the financial position of the fund or the sponsor. The reasons for this view are:

- The risk implications for a pension fund, with respect to its liabilities, of investing in a particular asset class are broadly similar regardless of how the asset class is managed. The risk level associated with investment in equities, for example, will be considerably higher than investing in long-term government bonds that are a closer match for the liabilities. But the level of risk associated with managing the equities with a short or a long-term approach will be within a narrow margin. Thus, the selection of different asset classes has a much greater bearing on managing the risk with respect to pension fund liabilities than the form of management.
- A long-term approach, as defined by the Marathon Club, with its emphasis on preservation of capital and absolute return, should imply less downside risk than a short-term approach.
- The Marathon Club believes, like Peter Drucker, that a series of short-term approaches is unlikely to generate the desired return.

To the extent that a fund has a short-term horizon, it will need to divest assets in the short-term to fulfil its obligations. This should be reflected in its asset allocation: a fund in this position will need to invest in assets that it can sell easily and bear little liquidity risk, e.g. government or investment grade corporate bonds.

Components of long term mandate



In contrast to some observers of the investment industry, the Marathon Club does not believe that merely extending the formal term of investment management contracts will lead to a long-term approach.

The components of a long-term approach highlighted in the definition proposed by the Marathon Club have to be embedded within the philosophy and process of the investment management organisation. Crucially, for such an approach to be successful and not abandoned mid-course, trustees must buy into the beliefs that underpin this definition.

Central to a long-term approach are the trustees' own investment beliefs. Trustees should endeavour to articulate their **beliefs** before venturing into long-term investing. Furthermore, the **leadership and governance** of the trustee or investment board has an important influence in forming, implementing and sustaining these beliefs. Implementation is achieved through setting clear investment **objectives**, ensuring appropriate **manager selection** and **alignment of financial interests** and through managing the **long-term relationship**.

How should managers be remunerated to align their behaviour with long term objectives?

The separation of interests of asset owners and their managers leads to an agency problem for owners. Though managers act as agents of owners, their objectives are not necessarily aligned with the owners. It could be argued that the *ad valorem* fee structure that is common in the industry encourages a long-term approach, because growth in fees comes from growth in asset values. However, the linkage is not sufficiently strong in itself. In addition, full alignment of interests requires alignment not only between investor and investment manager but also with the employees of the investment manager.

This may be why the best long-term investment performance is often found in boutique investment houses, where the investment manager has also invested its own money. The following excerpt from the third quarter newsletter of Eagle Capital Management Inc illustrates the point:

"In ancient Rome, when a bridge was completed, the architects and engineers who had initially designed it stood beneath the structure as the first carriages drove over. If the design was faulty, the bridge would collapse and they would be crushed. THAT is an incentive which aligns behaviour with client interest."

The Marathon Club strongly supports co-investment as probably the clearest and strongest mechanism for gaining alignment of interests.

The use of performance fees is more complex. There is an advantage to using performance fees only if it will change the investment manager's behaviour in the way intended.

If the investment manager does not have, at the outset, beliefs about the advantages of long-term investing which are already embedded in its investment management style and processes, what assurance is there that performance fees will change those beliefs and processes? The danger of an inappropriate performance fee structure is that it may encourage excessive short term risk taking, for example to meet an impending three or five year goal. In addition, many investment managers say that performance fee structures will not change their behaviour, and only a relatively small proportion of their mandates have such structures. Only a minority of trustees appear to be encouraging them.

The Marathon Club supports the wider use of performance fee structures, suitably tailored to each case.

The likely components of any performance fee structure might be:

1. A base fee, which might most appropriately be calculated to cover the manager's basic costs (excluding any performance related costs within the manager) plus a small margin.
2. Performance related fees, designed initially to bring total manager remuneration towards the level of a "normal" basis point fee for the asset class on the achievement of an agreed return.
3. A ratcheting effect, so that reward might progressively increase with out-performance of various "hurdles", subject to a ceiling or absolute cap.

Design of the fee structure will require negotiation with the investment manager and must be consistent with the levels of risk the trustees wishes the manager to take. The better the performance – not simply the higher the market – the higher will be the performance fee.

One feature that has been used to discourage trustees' change of managers for reasons solely to do with short-term performance is a sliding scale redemption charge. The redemption fees progressively reduce over the term of the mandate and may be fully withdrawn after some specified period. However, exemptions to the sliding scale redemption fees need to be built in and to include trigger events for review of the mandate which are non-performance related.

Relationship with the investment manager and monitoring

What is measured and monitored will have an influence on the relationship between trustees and investment managers. The quarterly monitoring process, with a focus on performance relative to an index has become the norm in the investment industry and has been blamed for promoting short-term behaviour by investment managers.

The Myners Review recommended that *"pension funds should provide fund managers with clarity about the period over which their performance will be judged",* so as to reduce uncertainty for managers.

The Marathon Club considers that it is the focus and content of the review meeting that has greater bearing on manager–trustee behaviour, than either the frequency of review or the lack of clarity around the term of the contract.

The content and conduct of review meetings can help build mutual trust between trustees and their managers. When trustees simply focus on performance without intimate knowledge of the process they are likely to encourage short-term behaviour. If the ongoing reviews inform the trustees of the investment manager's decision making process, so that they can assure themselves that the philosophy and process they bought into initially is intact, this will engender a relationship of trust. In long-term investing, the purpose of the ongoing review should be to help the trustees determine that they are still on track to achieve their long-term objectives.

Frequency of review meetings

In the early stages of a mandate, trustees and the investment manager may feel that it is necessary to meet frequently, e.g. quarterly. The regular pattern of meetings is best determined only when a good dialogue and understanding of the investment strategy and approach has built up between trustees and the manager. The depth of preparation and discussion for a formal review of a long-term investment mandate is likely to require a commitment of time such that an annual review cycle may be more appropriate, once the relationship is established.
Regardless of the cycle of formal review meetings, trustees can obtain quarterly reports from their in-house staff or investment consultant on the manager's performance and organisation.

Agenda and preparation

Trustees should set the agenda for the review meeting and agree the format of reports from the manager. Trustees need to be sufficiently briefed in order that they can ask pertinent questions. Investment advisors and internal staff have an important role in helping to set the agenda and prepare trustees for the review meetings.

Trustees also need to decide who they wish to see in the review meeting. Ultimately the portfolio manager is best placed to give an understanding of the investment portfolio. Yet, this practice can distract portfolio managers and therefore must be considered when deciding the frequency and location of the manager review meetings.

Contents of a review meeting

The Marathon Club recommends that a review meeting covers the following:

1. Changes to investment philosophy, process and systems. Trustees should encourage the manager's skills, allowing subtle adjustments to keep pace with evolving markets. In contrast, reactive changes to an investment process following a period of underperformance would be grounds for concern.

2. Changes to organisation ownership, general management and key staff compensation, particularly co-investment;

3. Continuity in key personnel;

4. Major client acquisitions and losses;

5. Regulatory issues;

6. Adherence to process and performance

It is, perhaps, inevitable that trustees will continue to look at the return and compare this to an index or the performance of comparable managers in order to get some sense of the context of their manager's performance. The Marathon Club advocates that the emphasis of the review ought to be on testing that the process and the development of assets within the portfolio conforms to the underlying philosophy or investment beliefs. The focus must not be on price-based, short-term performance measures. Such measures are an inappropriate way to decide whether to retain or change managers under a long-term approach.

> **"Compared with their predecessors, modern investors concentrate too much on annual, quarterly, or even monthly valuation of what they hold, and on capital appreciation and depreciation generally; and too little either on immediate yield or on future prospects and intrinsic worth."**
>
> **Keynes 1938**

The indicators for the portfolio review would be most helpful if they are based on the way the manager manages money and should be developed with input from the manager, at the final stage of manager selection.

Trustees should check whether the individual characteristics of the portfolio are consistent with the overall investment process, e.g. in terms of the number of holdings, concentration, type of holdings (small, large, growth or value oriented), turnover, themes, valuation characteristics (price-to-earnings, yield, manager's valuation, etc.) or fundamental characteristics (return on equity, operating margins, sales/earnings growth rates, etc.). Trustees should be able to test how new purchases conform with the investment philosophy and security selection process and how sales conform to the sell discipline.

From a snapshot of the portfolio, trustees should identify a very small number of holdings, possibly new purchases or holdings that are out of favour with the market, for a more detailed discussion. A case-by-case

analysis, as shown in Appendix C, can be the most insightful part of the monitoring process as it will help the trustees understand how the process is being applied, the depth of research and see the output of the investment philosophy.

As already described above, trustees should agree the metrics with the investment manager which will be used for evaluating the portfolio at the final stage of the manager selection.

The type of metrics agreed upon will vary according to the preferences of the trustees and the way the investment manager is managing the money. Some examples of the types of measures that could be relevant for monitoring long term mandates are provided in Appendix D.

Termination of a Manager

A mandate should be terminated if, based on a review process described above, the trustees conclude that the portfolio does not reflect the investment philosophy and process or that changes to the organisation or key individuals are such that the philosophy and process will not be deliverable in the future.

Trustees will generally need to be more tolerant of managers appointed for a long term mandate who may encounter occasional bumps in the road (experiencing periodic performance decrements in anticipation of a major pay-off).

The way forward

The Marathon Club believes that trustees of endowments and pension funds must fundamentally re-consider the way they invest.

This paper argues that a long-term approach is ideally suited to investors who have a long time horizon. A change of mindset is needed for investors to think of success in investing as participation in the growth of enterprises within the economy at various stages of their life-cycle. This is different from the widely followed approach of perceiving success as outperforming market indices over short periods of time.

The Marathon Club recognises that the change in mindset needed is significant. It cannot be achieved without the cooperation of all participants in the investment chain – trustees, investment managers and investment advisors. The role for each is clear:

- **Trustees must devote time to establish their investment beliefs and express their need for long-term investment in seeking advice;**
- **Investment advisors must raise trustees' awareness of a long-term approach through advice, discussion with and training of trustees.**
- **Investment managers must be prepared to offer investment products with a long-term approach, which includes appropriate pricing structures and reporting.**

Some might argue that there is insufficient supply of long-term investment products. We believe that the supply will follow demand. If trustees, supported by their consultants, ask for long-term approaches to investment and question managers on their approach, the products available will expand. This Guidance Note should help trustees to specify their need for long-term investment and create such a demand.