

# LONG-TERM MANDATES:

A DISCUSSION PAPER



**UNEP Finance Initiative**  
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**United Nations** Global Compact

An investor initiative in partnership with UNEP Finance Initiative and UN Global Compact

# THE SIX PRINCIPLES

- 1** We will incorporate ESG issues into investment analysis and decision-making processes.
- 2** We will be active owners and incorporate ESG issues into our ownership policies and practices.
- 3** We will seek appropriate disclosure on ESG issues by the entities in which we invest.
- 4** We will promote acceptance and implementation of the Principles within the investment industry.
- 5** We will work together to enhance our effectiveness in implementing the Principles.
- 6** We will each report on our activities and progress towards implementing the Principles.



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# INTRODUCTION

The Principles for Responsible Investment (PRI) established a policy and research work-stream in September 2013 to address barriers to the development of a sustainable financial system. One major barrier, according to over 90% of PRI signatories, is 'short-termism', which the Financial Times defines as "excessive focus on short-term results at the expense of long-term interests."<sup>1</sup>

Investors, on average, have become markedly more short-term in recent decades,<sup>2</sup> a pressure which flows through to corporate CEOs.<sup>3</sup>

The PRI believes a long-term investment perspective is a critical enabler of responsible investment as it encourages long-term stewardship of assets and value creation. Long-term investment is a well-documented topic, from the Kay Review<sup>4</sup> to Canada Pension Plan and McKinsey's Focusing Capital on the Long-Term.<sup>5</sup>

This paper builds on existing research as well as comments from consultation meetings in Edinburgh, Paris and Amsterdam, to present a range of potential ways in which investors can ensure a long-term investment horizon.

Depending on the investment governance model followed, these may be tailored for inclusion in mandates, complementing, and following-on from, the International Corporate Governance Network's work on model mandates.<sup>6</sup> It is presented as a discussion paper and does not represent the views of any one member of the Policy and Research Steering Committee. The Steering Committee is very conscious of avoiding a one-size fits all approach, recognising the diversity in the PRI signatory base.

The PRI recognises that a key step in determining an asset owner's approach towards investment horizons is strategic asset allocation among different asset classes. However, the focus of this paper is on investment decision making, focusing on listed equity.

The PRI welcomes examples of leading practice in adopting a long-term investment horizon. A more in-depth paper will follow, with suggestions for asset owners and investment managers.

**Please email case-studies and academic research on long-term investment to [will.martindale@unpri.org](mailto:will.martindale@unpri.org) by Friday 12th September.**

Our aim is to accelerate the shift from analysis to implementation, in order to achieve long-term sustainable returns and improve system wide capital allocation.

## POLICY AND RESEARCH STEERING COMMITTEE

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- **Mark Mansley,**  
*Environment Agency Pension Fund*
- **Bryan Thomson,**  
*British Columbia Investment Management Corporation*

**"It's important that asset allocation is appropriate for the liability of the fund. At Cbus many of our members will have money with us for more than 40 years."**

Louise Davidson, Cbus

<sup>1</sup> [http://lexicon.ft.com/?term=short\\_termism](http://lexicon.ft.com/?term=short_termism)

<sup>2</sup> See: <http://www.oecd.org/finance/private-pensions/48616812.pdf>

<sup>3</sup> [http://www.unglobalcompact.org/docs/issues\\_doc/lead/LEAD\\_ShortTermism.pdf](http://www.unglobalcompact.org/docs/issues_doc/lead/LEAD_ShortTermism.pdf)

<sup>4</sup> <https://www.gov.uk/government/consultations/the-kay-review-of-uk-equity-markets-and-long-term-decision-making>

<sup>5</sup> <http://www.fclt.org/en/home.html>

<sup>6</sup> [http://books.google.co.uk/books/about/ICGN\\_Model\\_Mandate\\_Initiative.html?id=sELpmgEACAAJ&redir\\_esc=y](http://books.google.co.uk/books/about/ICGN_Model_Mandate_Initiative.html?id=sELpmgEACAAJ&redir_esc=y)

# 1. LONG-TERM INVESTMENT DEFINITION

In discussions, PRI signatories recognised the importance of defining long-term investment.

## 1.1 WHAT IS 'LONG-TERM'?

Some investors link to the average life of liabilities, while others argue that it is the style of investment, rather than the holding period, that defines long-term investment.

The OECD defines long-term capital in terms of several characteristics – patient, engaged, and productive.<sup>7</sup> This is the definition which has been adopted by the European Commission.

Given the diversity of long-term investment definitions, asset owners may find it helpful to establish a definition of long-term investment, and include it in the mandate with their investment manager.

### QUESTION FOR CONSIDERATION:

What is your definition of long-term investment?

“For us, long-term investing is a process that centres on the fundamentals of the business, paying attention to market noise as a secondary consideration.”

Mark Mansley, EAPF

“The starting point for Alliance Trust is that long-term means the investor’s horizon is over five years.”

Justin Atkinson, Alliance Trust

“When it comes to choosing an investment strategy, the long run is not equal to the sum of the intervening short runs. Put simply, trying to achieve the best possible return each year is a recipe for doing badly in the long run.”

Paul Woolley, LSE<sup>8</sup>

<sup>7</sup> <http://www.oecd.org/pensions/private-pensions/49714860.pdf>

<sup>8</sup> <http://www.ft.com/cms/s/0/77637860-e974-11e2-bf03-00144feabdco.html#axzz35S3VJHHo>

## 2. INVESTMENT GOVERNANCE

This section highlights the importance of investment governance, with close alignment between asset owner and investment manager.

### 2.1 INVESTMENT BELIEFS

A statement of investment beliefs can be used to guide strategic asset allocation and, through mandate design, the investment decision making processes. Investment beliefs can also include the organisation's views on the value of ESG integration and active ownership.<sup>10</sup>

Asset owners and investment managers may agree on a statement of investment beliefs which sets out their investment approach. This could be communicated to beneficiaries and clients, explaining the relevance of a long-term investment approach.

### 2.2. INVESTMENT PRACTICE

Having agreed on a statement of investment beliefs, it is important to incorporate performance objectives and monitor implementation to ensure investment practice reflects beliefs.

### 2.3. LONG-TERM ACTIVE OWNERSHIP, COMPANY ACCESS AND QUALITY OF ENGAGEMENT

Many investors believe that corporate engagement adds value over time. This is because long-term engaged shareholders often have a deeper relationship with companies when compared to short-term investors.

The investment governance could promote frequent company meetings, voting and detailed company research, focussed on long-term strategic issues and value drivers.

Many companies actively seek long-term investors to join their shareholder register<sup>11</sup> as documented in the PRI and UNGC report, 'Coping, Shifting, Changing: Strategies for Managing the Impacts of Investor Short-Termism on Corporate Sustainability'.<sup>12</sup>

**"A long time investment horizon is a responsibility and an advantage."**

CalPERS Investment Beliefs <sup>9</sup>

**"The purpose of our engagement with companies is to instil a long-term management horizon and a holistic approach to ESG risks and opportunities. Unless structures to support this approach are in place throughout the entire investment supply chain, we risk being only as long-term as the shortest-term link in the chain, and, ultimately, failing to discharge our duties to the beneficiaries whose capital is at risk."**

Gordon Hagart, Australian Council of Superannuation Investors (ACSI)

#### QUESTIONS FOR CONSIDERATION:

**What is the effect of investment beliefs? What drives investment manager behaviour? What are the broader points of investment governance that enable a long-term investment horizon? Do you have examples of academic research to support your approach?**

<sup>9</sup> <https://www.calpers.ca.gov/index.jsp?bc=/about/newsroom/news/2013/investment-beliefs.xml>

<sup>10</sup> For example, NZ Super's return target is NZ T-bills + 2.5% over a 20-year rolling period. <http://www.nzsuperfund.co.nz/index.asp?pageID=2145879233>

<sup>11</sup> <http://www.bloomberg.com/news/2012-07-05/unilever-wants-short-soapy-showers-and-long-term-investors.html>

<sup>12</sup> <http://www.unglobalcompact.org/resources/851>

# 3. LONG-TERM MANDATE CONSIDERATIONS

The following section includes key ways asset owners can structure mandates to support long-term investing.

## 3.1. INVESTMENT MANAGER REPORTING AND ACCOUNTABILITY

Asset owners could require that investment managers report to them on the following information on investment portfolios:

- Developing metrics which focus on underlying value and strategy of the portfolio, and the companies within it.<sup>13</sup>
- Summaries of company engagement meetings<sup>14</sup> (for example number, content and impact),<sup>15</sup> and approach to integration and details of regulatory advocacy.

Asset owners and investment managers could also align reporting with the PRI's Reporting Framework,<sup>16</sup> as well as guidance provided in Aligning Expectations and the Value Driver Model.<sup>17</sup>

## 3.2. TURNOVER

High turnover can suggest shorter-term investment horizons, acting as a disincentive to effective corporate engagement. High turnover can also lead to increased transaction costs.

In discussions to date, signatories have made the following suggestions:

- Asset owners should monitor portfolio turnover and understand reasons for divergence from turnover expectations.<sup>19</sup>
- Investment managers should calculate, evaluate and report on portfolio turnover.
- Investment managers should calculate and report the costs incurred from turnover.

## 3.3. PERFORMANCE MONITORING

Asset owners could ensure that performance monitoring reflects their long term investment objectives. Possible ways to implement this are:

- Asset owners could clarify the broader criteria that managers will be judged against, such as: the development of the investment process (or of more concern "style drift"), organisational stability, team development and succession.
- Asset owners and investment managers could move away from a narrow focus on market-cap weighted benchmarks, and use options such as a broader benchmark aware approach, or multiple or hybrid benchmarks.

“Where ESG is an explicit investment belief, it will manifest itself in how the investor selects and appoints managers as well.”

Claudia Kruse, APG <sup>18</sup>

“Performance measurement is one of those good ideas that somehow got totally out of control”

Lars Dijkstra, Kempen Capital <sup>20</sup>

<sup>13</sup> See [https://www.eapf.org.uk/~/\\_media/Document%20Libraries/EAPF/Latest%20LGPS%20EAPF%20News/Mandate%20of%20the%20future%20article%201.pdf?dmc=1&ts=20140321T1850384978](https://www.eapf.org.uk/~/_media/Document%20Libraries/EAPF/Latest%20LGPS%20EAPF%20News/Mandate%20of%20the%20future%20article%201.pdf?dmc=1&ts=20140321T1850384978).

<sup>14</sup> [http://www.novethic.fr/fileadmin/user\\_upload/tx\\_ausynovethicetudes/pdf\\_complets/2013\\_ESG\\_indicators\\_study.pdf](http://www.novethic.fr/fileadmin/user_upload/tx_ausynovethicetudes/pdf_complets/2013_ESG_indicators_study.pdf).

<sup>15</sup> Again see ICGN model mandate, proposed model terms for reporting, page 20.

<sup>16</sup> See SAM 07.1: [http://www.unpri.org/viewer/?file=wp-content/uploads/2013-14\\_PRI\\_RF\\_03\\_SAM.pdf](http://www.unpri.org/viewer/?file=wp-content/uploads/2013-14_PRI_RF_03_SAM.pdf)

<sup>17</sup> <http://www.unpri.org/areas-of-work/reporting-and-assessment/reporting-framework/> or [http://www.unpri.org/viewer/?file=wp-content/uploads/Aligning\\_Expectations\\_2013.pdf](http://www.unpri.org/viewer/?file=wp-content/uploads/Aligning_Expectations_2013.pdf) or [http://www.unglobalcompact.org/Issues/financial\\_markets/value\\_driver\\_model.html](http://www.unglobalcompact.org/Issues/financial_markets/value_driver_model.html)

<sup>18</sup> See APG investment belief number 10: <http://www.apg.nl/en/apg-as-asset-manager>

<sup>19</sup> See ICGN Model Mandate, Proposed model terms for portfolio turnover, page 19.

<sup>20</sup> [http://www.the300club.org/Portals/0/The\\_300\\_Club\\_Paper\\_Lars\\_Dijkstra\\_From\\_short-term\\_salesmanship\\_to\\_long-term\\_stewardship\\_221012.pdf](http://www.the300club.org/Portals/0/The_300_Club_Paper_Lars_Dijkstra_From_short-term_salesmanship_to_long-term_stewardship_221012.pdf)

Some long-term investment managers have even moved to LIBOR, inflation,<sup>21</sup> or another liability measure as the benchmark for an equity mandate.

### 3.4. FEES AND INCENTIVES

#### A. PORTFOLIO MANAGEMENT COMPENSATION STRUCTURES

Asset owners may find it useful to understand how investment manager compensation structures are aligned with the mandate objectives.

#### B. FUND PERFORMANCE FEES

Asset owners could communicate to beneficiaries how compensation and performance are aligned.

#### C. FEE DISCOUNTS FOR LONG-TERM COMMITMENT

In discussions, some signatories suggested there should be a correlation between length of mandate and fee: the longer the mandate the cheaper the fee.

### 3.5. RISK MEASUREMENT

Many long-term investors have concluded that existing risk indicators such as volatility, standard deviation and tracking error provide limited information on long-term risk. Additionally, tracking errors only measure risk in comparison to the benchmark, not the wider market or the asset owner's liabilities. Asset owners and investment managers could consider multiple risk measures, including conditional volatility measures of downside risk or maximum drawdowns.

### 3.6. FUND STRUCTURES

Long-term public equity investors may be able to learn from private equity investment vehicles, many of which have a tenure of 10 years or more. New investment vehicles, such as European Long-Term Investment Funds (ELTIF)<sup>23</sup> could be used to hold long-term investments in public equities. Such structures may allow asset owners to better match their long-term liabilities.

Some asset owners are looking to replicate relevant aspects of private equity mandates in public equity mandates, for example, compensation claw backs or lock-ups.

“During the financial crisis, one investment manager had a tracking error of 11%. The investment out-performed the benchmark by 20%. That’s not an error.”

Mark Mansley, EAPF

“The increasing focus on forecasting risk, and the emergence of volatility as a popular measure of that risk, is a disappointing response by the investment industry to the recent difficulties it has faced.”

Stefan Dunatov, Coal Pension Trustees Investment Limited<sup>22</sup>

#### QUESTIONS FOR CONSIDERATION:

**Do you have experience of implementing long-term equity mandates? What worked? What didn't work? What internal and external barriers did you face in implementing long-term mandates? As a long-term investor, what additional considerations would you recommend? Does your approach differ for other asset classes, for example, fixed income mandates? What can public market mandates learn from private market investment structures?**

<sup>21</sup> See Legal & General's Real Income Growth Strategy, <http://www.ft.com/cms/s/0/b2380888-dce5-11e3-b73c-00144feabdc0.html#axzz35S3VJHHo>

<sup>22</sup> <http://www.the3oocclub.org/Portals/0/Stefan-Dunatov-defining-true-risk-09-06-14.pdf>

<sup>23</sup> <http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:52013PC0462>



## 4. OVERCOMING BARRIERS TO ENABLE LONG-TERM INVESTMENT

The following section gives examples of barriers both asset owners and investment managers may need to overcome to achieve long-term investment horizons.

### 4.1. PASSIVE INVESTMENT STRATEGIES

One of the challenges that many passive investors face is the presence of companies in their equity benchmarks that have poor corporate governance structures. Investment managers that fully replicate these benchmarks are required to purchase shares of these companies. Investment managers could consider alternative “smart beta” benchmarks (such as fundamental or equal weighted indexes).

Passive investment mandates could require engaged ownership, reinforced by strong stewardship codes. Asset owners and investment managers could also engage with listing authorities, and potentially advocate for index providers to exclude companies, if they consistently fail to meet minimum corporate governance standards.

### 4.2. ACTIVE INVESTMENT STRATEGIES

In discussions to date, some signatories have highlighted that active long-term portfolios are often more concentrated.

Managing an active portfolio may require detailed research, monitoring of information and active ownership. A portfolio that is highly diversified, global, intermediated and rotating may negatively impact engagement efficiency.

The quality of engagement also depends on the quality of dedicated resources, including a long-term knowledge of the company.

### 4.3. ROLE OF THE ASSET OWNER IN THE CORPORATE ENGAGEMENT PROCESS

An investment manager’s ability to incorporate ESG into the investment process, including engagement, should be part of an asset owner’s selection and appointment process for investment managers. ESG integration is then part of the delegated investment management authority, including the manager engaging with companies on behalf of the client. Keeping the asset owner abreast of ESG integration should be part of the investment agreement.

In meetings to date, some signatories have suggested that investment managers could consider inviting asset owners, which do not already engage, to join company meetings. The company will realise that the investment manager is serious about engagement, when they can show that it is driven by their clients, and ultimately, impacts their investment decision making.

### 4.4. BROKERS AND RATINGS PROVIDERS

Investment managers could provide financial incentives to brokers used for trade execution for the provision of research focussed on long-term risk and value.

“French GAP authorises the evaluation of long-term-held equity portfolios at a value in use, which may be expert-based or a moving average of market prices. These accounting valuation standards allow investing for the long-term, in line with modelled liabilities, rather than forcing to react, pro-cyclically, to short term market moves, as last-market-price-valuation may.”

Laurent Deborde, Caisse des Dépôts

“ESG-integration in broker selection can help to realise a shift towards long-termism. As part of the selection process we ask brokers about their RI-policy, seek improvement in corporate governance, ask about ESG-research and stimulate brokers to facilitate dialogue.”

Kris Douma, MN



## 4.5. STEWARDSHIP CODES AND REGULATION

Stewardship codes and regulation can be enabling of long-term investment, for example the Code for Responsible Investing in South Africa or the French Grenelle Laws. Regulation can also inhibit long-term investment, for example the European Union's Solvency II capital requirements and European Market Infrastructure Regulation (EMIR).

Asset owners and investment managers, individually or collaboratively, could engage policy makers, if not already, to prevent inhibiting regulation and promote regulation that enables long-term investment.

Engagement with policy makers will contribute to work the PRI started in 2010, on 'universal ownership' and 'why environmental externalities matter to institutional investors'.

**The PRI seeks more examples of successful investor engagement with policy makers on long-term investment.**

“National and international measures that facilitate internalisation of externalities, either through regulation, or through changing the financial incentive structure, can be beneficial for long-term investment.”

Kris Douma, MN

### QUESTIONS FOR CONSIDERATION:

**What is the academic evidence to suggest that more concentrated portfolios promote longer-term investment horizons? Which regulations do you see as most counterproductive / beneficial for long-term investing? What barriers are there to engaging with policy makers to promote regulation that encourages long-term investment?**

“The most active stock pickers have been able to add value for investors ... closet indexers have essentially just matched their benchmark, which has produced consistent underperformance after fees.”

Antti Petajisto, BlackRock<sup>24</sup>

### FOLLOW UP

The aim of this discussion paper is to share signatories' ideas and suggestions, to facilitate debate, and accelerate the shift from analysis of long-term investing to implementation. The PRI asks that you share your comments on the points raised, as well as suggestions of additional points for consideration.

Your feedback will form the basis of a more in-depth paper with suggestions for asset owners and investment managers to achieve the shift to a greater balance of investment time horizons.

To share your work, comment on this paper, or to arrange a call, please email [will.martindale@unpri.org](mailto:will.martindale@unpri.org).

The PRI is grateful to signatories for taking the time to share examples of best-practice, both in the preparation of this discussion paper and the report which will follow.

For further reading on long-term investment, the PRI has compiled a literature review which is available at [www.unpri.org/areas-of-work/policy-and-research/](http://www.unpri.org/areas-of-work/policy-and-research/).

<sup>24</sup> See: <http://www.cfapubs.org/doi/pdf/10.2469/fajv69.n4.7>

The PRI is an investor initiative in partnership with  
**UNEP Finance Initiative** and the **UN Global Compact**.

#### United Nations Environment Programme Finance Initiative (UNEP FI)

UNEP FI is a unique partnership between the United Nations Environment Programme (UNEP) and the global financial sector. UNEP FI works closely with over 200 financial institutions that are signatories to the UNEP FI Statement on Sustainable Development, and a range of partner organisations, to develop and promote linkages between sustainability and financial performance. Through peer-to-peer networks, research and training, UNEP FI carries out its mission to identify, promote, and realise the adoption of best environmental and sustainability practice at all levels of financial institution operations.

More information: [www.unepfi.org](http://www.unepfi.org)



#### UN Global Compact

Launched in 2000, the United Nations Global Compact is both a policy platform and a practical framework for companies that are committed to sustainability and responsible business practices. As a multi-stakeholder leadership initiative, it seeks to align business operations and strategies with 10 universally accepted principles in the areas of human rights, labour, environment and anti-corruption, and to catalyse actions in support of broader UN goals. With 7,000 corporate signatories in 135 countries, it is the world's largest voluntary corporate sustainability initiative.

More information: [www.unglobalcompact.org](http://www.unglobalcompact.org)

