"HOW WE INVEST" WHITE PAPER

THE ADVANTAGES OF BEING A LONG-TERM INVESTOR

By Sue Brake and Rishab Sethi,
Guardians of New Zealand Superannuation

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www.nzsuperfund.co.nz
email:enquiries@nzsuperfund.co.nz

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PREFACE

This paper is a summary of one of a series of internal Guardians discussion workshops. We'd found ourselves having discussions about a specific investment where what we were really debating was a much more fundamental investment issue. The workshops were designed to explore team members' views, and understand the basis of internal agreement and disagreement, on a range of these fundamental issues. We knew that we were not necessarily going to resolve all of these issues, but we would come away with a better understanding of the key differences in opinion. Most importantly, we also considered the implications of each issue for how we construct our investment portfolio.

Holding the workshops, and developing these papers, has helped us provide a consistent vision to staff, to focus our time and resources appropriately and to avoid re-litigating some of the fundamental investment questions that investors deal with on an ongoing basis. I hope they also enhance your understanding of how we go about investing the NZ Super Fund.

Matt Whineray
Chief Investment Officer

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WHAT IS A LONG-TERM INVESTOR?

Before we define a long-term investor it is useful to consider who is not.

A long-term investor does not base investment decisions solely on the returns expected over short time periods of, say, a year or two. This is the most common definition of a short-term investor. Such behaviour can lead to small pieces of news without much information content having disproportionate impacts on the price of shares or other assets. This can lead to pro-cyclicality, as all investors respond to the same news in the same way, rather than allowing for a diversity of opinion on the implications of the news for the long term.

Similarly, an investor whose key investment decision-making motivation is to avoid being a negative outlier in comparison to peer-funds, is not a long-term investor.

For us, the most useful definition of a long-term investor is *"an investor who can hold any investment strategy for as long as they wish"*.

This definition is consistent with the idea that long-term investing is not just about the horizon over which you hold an investment or measure returns, but also about the control that you have over your capital.[1]

To maintain sufficient control to hold any investment for as long as he or she wishes, a long-term investor will have:

- limited claims on the capital, including a surplus of assets relative to liabilities, and sufficient liquidity;
- the ability to make independent, commercial decisions which might include a clear commercial objective, relatively low levels of regulatory constraints and being at arms-length from political considerations; and
- good governance including key stakeholders who are aware of what it means to invest for the long term; performance metrics and individual bonus systems that reward pay-offs over the chosen horizon; and relatively low levels of agency risk, including not being driven by reputational or career concerns deriving from short-term comparisons.

It is also importat to note that a long-term investor does not necessarily hold an investment for a long period. A long-term investor might hold an investment for a short period, but has the option to hold it for a longer period if it leads to a better risk-adjusted return.

IS THE GUARDIANS A LONG-TERM INVESTOR?

The Fund certainly has a long horizon and the Guardians have operational independence, both of which we consider to be our endowments:

- pay-outs to the Government to partially fund New Zealand Superannuation are not projected to start until 2029-30, and the Fund will continue to grow in size for many decades in real terms, peaking at around a third of GDP in 2080;
- our governing legislation requires the Guardians to have an independent Board of investment professionals nominated by an independent nominating committee (giving us double arms-length independence).

We also choose to act long-term. We communicate early and often to our stakeholders about what our long-term focus means for our investment strategies and the returns we expect from them, including, crucially, that it can sometimes mean our returns over any short time period could be volatile. We are conscious in our investment approach of agency risk and have a remuneration programme that is geared toward long-term returns and whole of Fund performance.

So, we believe that we are a long-term investor, able to choose to take a long-term perspective, with control over the capital of the Fund.

1 Ang and Kjaer (2012) refer to this as "captured" capital that will be drawn down only in the distant future. See Ang, A. and K. Kjaer, "Investing for the Long Run", Working Paper available at: papers.ssrn.com/sol3/papers.cfm?abstract_id=1958258, 2012.

WHAT ARE THE ADVANTAGES?

We believe that the advantages to being a long-term investor stem from the increased number of options available. A long-term investor can choose to invest in a wider range of investments than a short-term investor might consider, including riskier and more illiquid investments.

How a long-term investor chooses to take advantage of that increased optionality will depend on his or her investment beliefs. The clarity of those beliefs and the role they play in various investment opportunities is absolutely key.

For instance, we believe that returns can revert toward their average over time. As a long-term investor, we have a stable risk aversion. It therefore makes sense to us to be an opportunistic and contrarian investor. When the market is more risk averse than usual, our stable risk aversion allows us to see value in overweighting the most oversold assets. When the market is less risk averse than usual we will underweight the most favoured assets. This is the basis of our Strategic Tilting programme. A long horizon allows us to exercise the option to be contrarian. We believe that returns will revert to a more normal level but we don't attempt to time when this might happen. This requires us to be able to hold positions for potentially long periods of time.

Our view is that the cost-of forced sales can be priced into illiquid assets creating a price-discount. Buying an illiquid asset, however, will not automatically bring about an advantage to a long-term investor. When the price-discount is large, investors who do not currently have these assets in their portfolio can allocate a small proportion to them in such a way that the chance of them being forced to sell these assets is minimal. If there are many investors who can absorb that risk in their portfolio, there will be a limit to the size of the price-discount and therefore to the advantage to a long-term investor.

We believe that we can also benefit from long-term partnerships with other long-term investors whose endowments and beliefs are aligned with ours. We co-invest with peer funds and we have strategic relationships with a small number of investment managers. We also engage with a number of investee companies and managers on environmental, social and governance (ESG) issues, as we believe that ESG factors are material to long-term returns.

Finally, we think that long-term influences, even when widely accepted, sometimes may not be priced-in by the market, and so we are also an investor in selected long-term themes. These include:

- the unsustainability of current resource usage patterns;
- the inefficiency of emerging markets; and
- population ageing and other demographic shifts, such as increasing urbanisation of many developing countries.

Being able to wait patiently for themes to play out is another potential advantage to a long-term investor.