LOOKING TO THE LONG TERM

Free your managers, and returns could follow.

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Long-term unconstrained or index-insensitive mandates offer conceptual benefits. However, behavioural factors make this type of mandate inappropriate for many investors. This article discusses these issues and suggests possible ways of addressing the behavioural challenges.

The Benefits of Long-Term Mandates

Potential benefits arise from the simple belief that the best results in investment management are achieved through freedom in the hands of the most skilled investors. The goal should be to maximize long-term returns without placing undue risk on pension plan solvency, rather than controlling risk relative to an index.

Long-term unconstrained mandates offer greater expected returns as managers hold only the stocks they have a genuine long-term belief in. Managers are free from index constraints at stock, sector and country levels, increasing expected return. Contrary to conventional wisdom, this type of mandate is not necessarily high-risk: there is typically no greater risk to capital with an equally weighted 40-stock portfolio than there is in a global index.

Long-term mandates also benefit from low turnover and transaction costs. De-emphasizing short-term relative performance should encourage managers to invest for the long term rather than speculating on short-term performance—a strategy that is often hazardous to long-term wealth. For example, CSFB strategist Michael Mauboussin analyzed the 31 top-performing U.S. general equity funds over 10 years to the end of 2002. He found some attributes that set this group apart from the majority, the most striking being low turnover. Positions in the top-performing funds were held on average for more than three years, versus an average across U.S. equity funds of less than one year. None of the top-performing funds had turnover in excess of the average. The high turnover of the average fund highlights that speculation rather than investment is at the heart of the industry. While active managers may underperform in aggregate, holding positions with a genuine long-term view is a key driver of success.

Behavioural Challenges

Given the potential benefits of long-term mandates, why is the industry obsessed with benchmarks, tracking error and short-term relative performance? The greater potential for significant underperformance introduces behavioural factors that make this type of mandate inappropriate for many investors.

The principles of peer pressure and regret aversion encourage investment professionals to take the safe option. Consultants and plan sponsors favor safe decisions to avoid the potential damage to reputation of an incorrect decision, and fund managers risk losing assets—and ultimately their jobs—if they underperform even in the short term. Rational agents are not necessarily rational investors.

How can we mitigate the behavioural biases?

• De-emphasize short-term performance. Short-term performance tells us nothing and encourages investment managers and plan sponsors to engage in irrational behavior. Investment managers become speculators and plan sponsors are likely to chase investment trends. Investment performance should be the outcome of an effective investment strategy applied consistently over time.

• Clear qualitative criteria for firing managers should be established at the outset. Justifiable reasons for reviewing existing managers are changes in key personnel, changes of approach, poor long-term (not short-term) performance, and poor service or operations problems.

• Board structures may impact behavioural biases. Do board structures encourage ownership of decisions, or does collective decision-making contribute to a herd mentality? Is there sufficient stability to encourage investing for the long term?

In summary, long-term mandates offer conceptual benefits, but regret aversion and a focus on short-term performance may be difficult to overcome. ∎