ASIAN BUREAU OF FINANCE
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The Why, What and How of Long-term Investing

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What is long-term investing?

1) Ability to pursue investment strategies over varying horizons (and stick with them!)

2) Need to meet long-term (often multi-decade or multi-generation) liabilities

3) Investing long enough for *structural changes* in mission/liabilities to occur

Why invest for the long run?

- Harness wider array of investment strategies
- Ride out short-term fluctuations in returns*
- Profit from periods of elevated risk aversion or short-term mispricing*
- Exploit illiquid investment opportunities*
- De-risk pre-emptively in times of stretched valuation & mounting latent risks

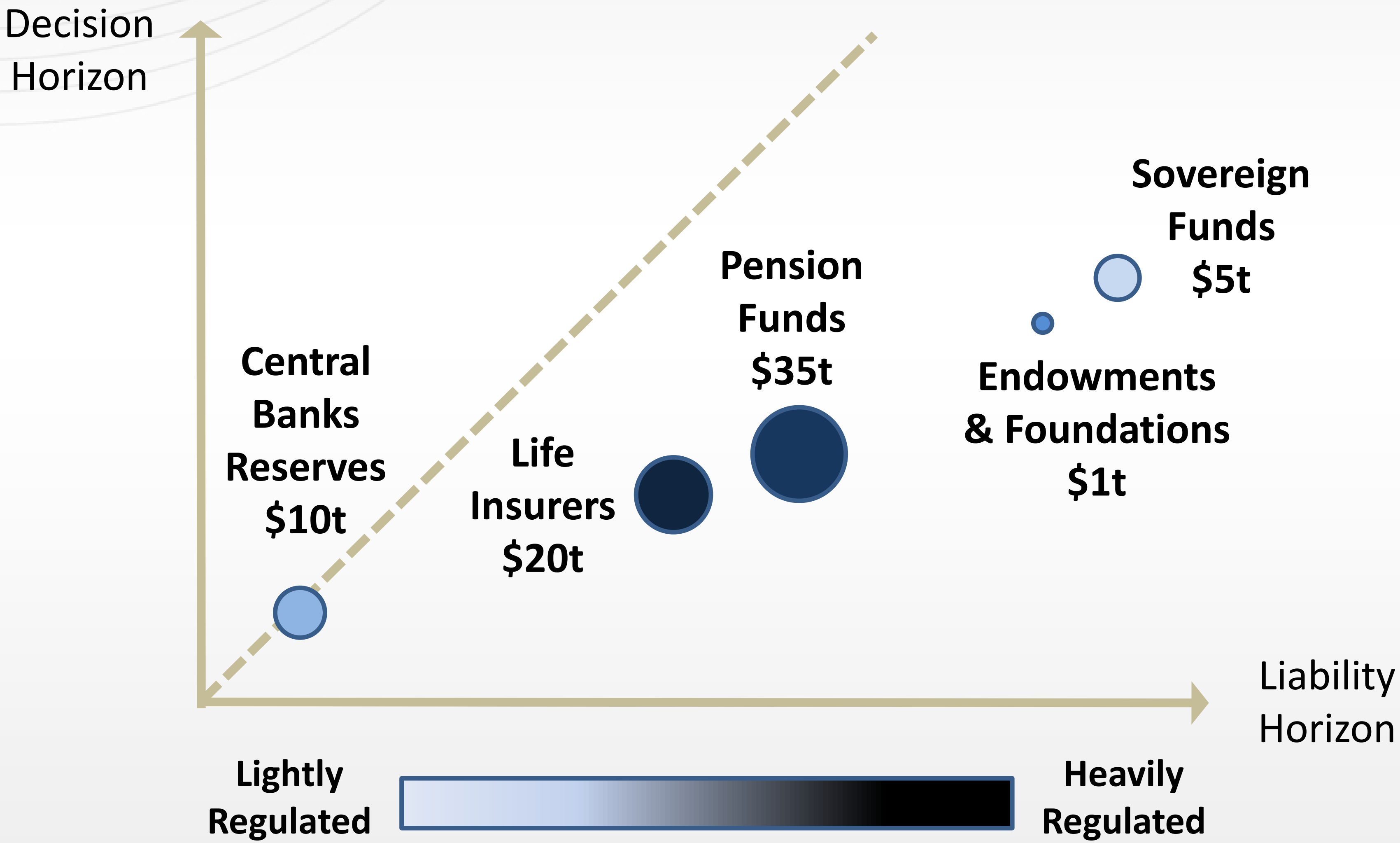
**Investing for the Long Run, Ang & Kjaer (2011)*

What impedes long-term investing?

- Propensity to sell winners early and ride losers longer (‘disposition effect’)
- Pro-cyclical investment biases arising from:

  a) herd instinct b) prudential regulations
- Misalignments of interests and time horizons among managers, fiduciaries and sponsors
- Performance, risk and incentive measures incommensurate with investment objectives

Who are the long-term investors?



How to invest for the long run?

- Traditional asset allocation model*
- Endowment model [Yale; Harvard; MIT]
- Factor allocation model* [CalPERS; ATP]
- Opportunity cost model* [CPPIB; GIC]
- Dual strategic/operational benchmark model [NBIM]
- Risk parity model [Bridgewater; AQR]
- Long-term business ownership model [BRK; Temasek]

Traditional asset allocation model

- Centered on a quasi-static *policy portfolio* (‘policy beta’) controlled by trustees with modest value-add (‘alpha’) within each asset class
- Longer time horizon needed to harvest equity & liquidity risk premia while tight link between policy & actual portfolios imposes rigidity
- Lack of transparency on underlying risk drivers and sources of skill-based value creation, especially for privately traded assets

Factor allocation model

- Premised on belief that asset returns can largely be explained by parsimonious set of common factors, e.g. *real interest rate, growth, inflation (realised & expected), volatility* [CalPERS]
- By design, factor models provide higher transparency on systematic risks but suffer from investability and stability issues
- Use of factors also complicate communications with stakeholders, hence slow adoption even among the converted

Opportunity cost model

- A *reference portfolio* comprising liquid assets acts as realistic, cheap-to-replicate passive alternative
- Investments outside of reference portfolio (such as RE, PE & infrastructure) are funded from best proxies (‘projections’) of reference betas which enhances risk and return transparency after adjusting for leverage & illiquidity
- Residual risks (orthogonal to reference betas) are controlled by active risk budget and provide *raison d’etre* for investing in alternatives

Keys to successful long-term investing

- Adopt robust investment model
- Embrace implied logic and risk discipline
- Build strong governance & resilient organisation
- Balance *risk efficiency* against *risk control*
- Check against pro-cyclical biases
- Look out for contingencies & tipping points
- In the end, it *always* boils down to PEOPLE…