The Why, What and How of Long-term Investing

Sung Cheng Chih

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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?

- Central Banks Reserves $10t
- Life Insurers $20t
- Pension Funds $35t
- Sovereign Funds $5t
- Endowments & Foundations $1t

Decision Horizon

Liability Horizon

Lightly Regulated

Heavily Regulated

Heavily Regulated

Lightly Regulated
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’être 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...