The AMBACHTSHEER Letter

Sustainable Pension Design • Effective Pension Management

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LONG HORIZON INVESTING:

HOW SHOULD WE MEASURE 'PERFORMANCE'?

"What gets measured gets managed."

Peter Drucker

The Shift to Long Horizon Investing

Last month's *Letter* suggested that an important key to mainstreaming 'responsible investing' was to rename it 'long horizon investing', or LH investing for short. This is in fact happening. The UN wants more LH investing. The OECD wants more LH investing. The World Economic Forum wants more LH investing. The 100 participants in the recent Rotman ICPM-Generation Foundation workshop described in last month's *Letter* identified 10 concrete steps their organizations could take towards creating and managing functional LH investment programs. Clearly, there is visible movement towards the idea of LH investing, and it seems to be gaining momentum.

Indeed, two of the action steps that came out of the Rotman ICPM-Generation Foundation workshop relate directly to creating LH investment programs. The first focused on what pension funds should do inside their own organizations; the second on what funds should do collectively:

1. "Design and implement concentrated long horizon investment mandates, and ensure that we have the necessary resources to successfully implement them."
2. "Develop a 'model investment mandate' through an organization like ICPM that can be widely shared and reported on by investors."

Interestingly, an example of such a model mandate was presented and discussed at a recent ICPM Forum and described in an article in the Spring 2012 issue of the Rotman International Journal of Pension Management (RIJPM): "*Really* Investing for the Long Term: a Case Study" by Alex van der Velden and Otto van Buul.

This building momentum towards LH investing raises an important governance question for organizations that choose to manage such programs. Paraphrasing Peter Drucker: 'if we are going to manage a LH investment program, how should we measure its performance?' A simplistic response would be: 'over a long horizon evaluation period'. It is simplistic because it is not realistic for the oversight board of an investment organization to wait 10-20 years to see how its LH investment program turned out. Clearly, oversight boards should insist on sensible progress markers along journeys lasting 10-20 years. What might these sensible markers look like? The goal of this *Letter* is to address that question.

Sensible Progress Markers

So what is it that we want to measure the performance of? What is LH investing? Readers of this publication know that we follow Keynes in thinking of it as participating in a process that converts savings into wealth-producing capital, which in turn pays income back to investors. It is not trading securities in investment markets with the goal of outsmarting other traders (Keynes called this 'beauty contest' investing). But ironically, it is the success or failure of these 'beauty contest' trading strategies that most current investment performance measurement systems are best designed to measure.

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How do we re-orient investment performance measurement away from trading success or failure, and towards success (or failure) to create value for beneficiaries in a longer term timeframe? In our view, the answer lies in focusing less on short term total return outcomes, and more on the size, quality, and growth of the income stream the investments are producing, and on the governance and managerial effectiveness of the investee organizations actually producing the income stream. With this re-orientation, it becomes reasonable for oversight boards to ask for regular progress reports on the performance of the investment income streams, and on the health and effectiveness of the investee organizations generating those income streams.

Assessing Investee Organization Health and Effectiveness

How can we monitor the health and effectiveness of the investee organizations generating our investment income streams? Another one of the resolutions that came out of the recent Rotman ICPM-Generation Foundation workshop was that investee organizations should use the new Integrated Reporting protocol developed by the International Integrated Reporting Committee, which fundamentally redefines the concept of 'material information'. The four key <*IR*> concepts are:

1. From Mission/Vision to Business Model: develop a clear narrative that links the purpose of the organization to a description of how it converts inputs to outcomes. This conversion process involves assessing opportunities and risks, strategy and resource allocation decisions, and results evaluation, all overseen by a robust governance process.
2. The Six Capitals: think carefully about the relevance and importance for organizational success of six forms of capital: financial, manufactured, intellectual, human, so-relationship, and natural. All are stores of value, and all are potentially important inputs into the organization's business model, and hence potential factors in assessing the organization's long term viability.
3. Outcomes: are the internal and external consequences (positive and negative) resulting from the organization's business activities and outputs. Internal examples could relate to employee morale or organizational reputation. External examples could relate to customer satisfaction or environmental effects.
4. Value Creation: goes beyond assessing the organization's financial performance (e.g., as might be measured by changes in the present value of future cash-flows). A broader context includes an understanding that future cash-flows and other conceptions of value are dependent on broader definitions of 'capital' (e.g., competitive advantage), and an expanded range of time horizons.

See our recent May *Letter* for a more detailed exposition of the <*IR*> reporting protocol.

In an article in the Fall 2012 issue of the RIJPM, corporate strategic advisors Roland Burgman and Mark Van Clieaf offer a more finance-oriented perspective on assessing the health and effectiveness of investee corporations. They emphasize the importance of metrics such as Economic Profit (EP) and Return On Invested Capital (ROIC). EP captures corporate profitability net of a capital charge. ROIC minus the weighted cost of capital captures a corporation's excess return on corporate capital employed. They note that management's job is to organize to maximize longer term EP growth and excess ROIC on a sustainable basis through continuous innovation, using all forms of capital available to the organization. They also note that many executive compensation schemes in the corporate sector today are not driven by these financial and non-financial indicators of longer term value creation.

The key intended point in this section of the *Letter* is that engaged LH investors know a lot about the organizations they invest in. They have clear expectations at the time the original investment is made. They have effective tools to assess actual unfolding investee organization behavior and results versus expectations, and they will engage the boards and managements of these organizations when deemed necessary.

Investment Income vs. Price 'Performance'

A key element in the model of long term value creation we are describing is that investee organizations return free cash-flow back to investors. Investors in turn spend that investment income (e.g., on making pension or endowment payments), or they re-invest it. Either way, the 'performance' question is: how is the investment working out versus expectations? Repeating the points already made above, committed long horizon investors have information

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systems (both quantitative and qualitative) that allow them to be on top of 'actual vs. expectations' outcomes for all of their long horizon investments. So specifically, they know the strategic plans of their investee organizations, they know actual outcomes vs. strategic plans, they track metrics such as EP and ROIC vs. the weighted cost of capital, and they know the investee organizations' payout policies (see, for example, the Van Der Velden/Van Buul article cited above).

All this should produce a predictable investment income stream from a LH investment program back to the investment organization. Whether that is in fact happening (or not) should be a critical focus for performance measurement. Why? Because capital allocated to a LH investment program should be patient capital, with only the investment income it generates available for pension or endowment payments, or for re-investment. Shorter term capital value dips should be of no consequence in this case...unless they reflect an impairment of the investee organization's future ability to pay out investment income. As the investment horizon stretches out into the longer term, healthy, rising income streams will eventually produce rising capital values as well.

Monitoring Investment Income Production: a Simple Protocol

So what does a protocol that monitors investment income production look like? To our knowledge, this question was first addressed in an article by Robert Jeffrey in a 1977 Journal of Portfolio Management article titled "Internal Portfolio Growth: the Better Measure", with the subtitle explanation "Unless you're in a liquidating mode, what really matters is the growth in earnings and dividends, not the market value, of your portfolio". Jeffrey observed in his article, as we do here, that investment income behavior is much more predictable than changes in capital values, and that presumably, investment managers monitor predicted investment income experience vs. actual experience closely over time. To his surprise, he found that "no managers who we contacted were able to answer this question satisfactorily".

A Harvard MBA by training, and the CEO of a manufacturing company by experience, Jeffrey designed a simple investment income monitoring protocol himself. As he had converted the manufacturing company into a family investment company by selling its business assets for cash, he had strong personal motivation to do so. Today, almost 40 years later, Jeffrey's protocol (improved and updated over time) continues to provide the board of directors of the family investment company with valuable investment income 'performance' information critical to determining the dividend payout policy of the company. A simplified mock-up of it is set out in Table 1.

With this investment income monitoring protocol as a guide, the company has been able to achieve its

Table 1: A Simple Investment Income Monitoring Protocol

Dividend Income	Is actual dividend income in line with expectations? If not, why not? Answering this question requires tracking dividend payout policies, actual dividend changes, currency impacts, asset mix changes, etc. Looking ahead, what should we expect from here?
Interest Income	Is actual interest income in line with expectations? If not, why not? Answering this question requires tracking the shape of the yield curve, bond portfolio duration, use of leverage, currency impacts, asset mix changes, etc. Looking ahead, what should we expect from here?
Other Income Sources	(e.g., security lending, option writing): Is actual income from other sources in line with expectations? If not, why not? Looking ahead, what should we expect from here?
Total Investment Income	Is actual total investment income in line with expectations? If not, deviations will be explainable based on analysis of the investment income components making up the total. Looking ahead, what should we expect from here? Are we on track to meeting our longer term goals? If not, what are our decision options?
Distributions	How are we spending our investment income? Is it in line with our goals (e.g., payout vs. re-investment)? What are the communication implications to beneficiaries? Looking ahead, are our projected distributions in line with our distribution goals? If not, what are our decision options?
Cash-Flow	Are we cash-flow positive, neutral, or negative? Is this in line with expectations? If not, why not? Looking ahead, what should we expect from here? If projections show we will go cash-flow negative, what are the action implications?

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primary long horizon objective: to pay out a growing stream of inflation-adjusted dividends to family beneficiaries over time, while also maintaining the capability of corporate assets to continue to do so into the indefinite future.

Since inception almost 40 years ago, both corporate assets and annual dividends paid out to beneficiaries have doubled in real terms. We examined this remarkable governance achievement of the *Family Endowment Company* more closely in our November 2012 *Letter* titled "On Defining and Achieving Investment Goals: Why We Need To Get Back To Basics".

Total Fund Return Still Matters

The primary message of this *Letter* is that LH investors should care about, and really understand the investment income performance of the funds they manage. This does not mean that they should ignore total fund return performance (i.e., returns that include capital value changes). Instead, the point is that LH investors understand the importance of putting the horse (income) before the cart (capital). They understand that ultimately, it is the quantity and quality of the investment income stream that drives capital values, and not the other way around. This understanding gives LH investors a fundamental advantage over short horizon 'beauty contest' investors. Even if LH investors are only approximately right about the quantity, quality, and price of investment income streams they are buying and holding, they should be able to generate higher risk-adjusted net total returns over long periods of time (i.e. 10 years or longer) than most short -horizon investors playing trading games. Actual *Family Endowment Company* total return results are consistent with this hypothesis.

We end by going back to where we started. 'Responsible investing' is being mainstreamed by changing the conversation to 'long horizon investing'. This transformation requires that we think carefully about the performance measurement implications of LH investing. This *Letter* argues this means separating the role of the income horse from that of the capital cart, and shows how this can be done. We must measure what we want to manage.

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416.925.7525 www.kpa-advisory.com