The Investors' Dilemma: Why 2016 May Be a Turning Point

by Barry Gillman, CFA[1]

The Investors' Dilemma

Many institutional investors ostensibly support the idea of focusing on long-term horizons. "Short-termism" suggests speculation, with exposure to the randomness of volatile markets. For institutions, the investors' dilemma is that their obligations are long term but regulatory and behavioral pressures increasingly exert short-term influences on their decisions. Institutional funds and their investment managers are stewards of the capital entrusted to them, with liabilities that may have a multi-decade or even a multi-generational time horizon. They must maintain a long-term perspective.

Investment Leaders Make a Stand

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While the notion of long-term investing may sound compelling, in practice implementation has proved tough. The good news over the past decade is that some of the world's largest institutional investors have begun to coordinate to promote the concept of long-term investing, and to find ways to resist short-term influences.

In this article we highlight four developments in 2016 that may be catalysts to broaden this movement to the rest of the institutional investment industry. Alone, these four may not change the world (or even the investment industry) but they do provide increasing evidence of industry leadership moving back towards "long-termism." And if enough institutions and managers support these initiatives, then we believe there is a chance for genuine change – over the long term of course.

Four New Developments in 2016

1. In early 2016, S&P announced a new index, the Long-Term Value Creation ("LTVC") Global Index. According to a press release from S&P Dow Jones Indices, the index measures companies "that have the potential to create long-term value based on sustainability criteria and financial quality." Six of the world's largest institutional investors[2] have voiced support and pledged $2 billion in aggregate to funds tracking the LTVC Index. These institutional investors are putting serious money into an agreed, unified approach. Institutional investors worldwide may want to pay attention to this initiative.

   The LTVC Index itself is intriguing. While an index, it has significant active exposure relative to the widely used MSCI ACWI global benchmark (Active Share of 79 relative to the MSCI ACWI). Although it includes a sustainability measure, it's not a conventional ESG ("Environmental, Social and Governance") approach. For example, as of March 31, 2016, three of the top 20 constituents are tobacco stocks. Country and sector weights are materially different from market cap benchmarks: fewer financials, less N. America and more Europe and emerging markets ("EM"). In fact, four of the five largest non-U.S. constituents are EM stocks. For a more detailed assessment, please see the Appendix.

2. Legislators face a true dilemma regarding how pension liabilities are treated in financial statements. Historically, actuarial valuations have used a long-term horizon in assessing a fund's ability to meet its liabilities. However, the size of some plan deficits, lower bond yields (hence higher liabilities), and periodic financial crises have led regulators to focus on how to mitigate systematic risk in the pension

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[2] Canada Pension Plan Investment Board, GIC (Singapore), Ontario Teachers (Canada), ATP (Denmark), New Zealand Super, and PGGM (Netherlands). While voicing support for the LTVC Index, New Zealand Super has not committed funds to the Index.

system, leading to increased use of mandatory mark-to-market valuations, especially in the U.S. and Canadian private pension sectors. For institutions the impact is to shorten investment time horizons to avoid breaching a mark-to-market solvency test. For legislators the dilemma is that enforcing mark-to-market can reduce the short-term risk of plan failure (by forcing sponsors to contribute more), but at the expense of industry viability, as plan sponsors close their defined benefit ("DB") plans as too expensive to maintain.

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In Canada, 2016 has seen the first reversal of this short-termism trend. The province of Quebec passed a bill eliminating its pension mark-to-market solvency test, effective January 1, 2016, replacing it with a long-term "going concern" test. It's possible this will give Quebec a competitive advantage with sponsors regarding their DB plans. Not to be left too far behind, Ontario announced it is expediting its study of a similar measure. If both these large provinces move away from mark-to-market, others may need to consider this seriously, as well.

3. For more than 30 years, Keith Ambachtsheer has been a pioneer and thought leader in the global pension industry. His new book *The Future of Pension Management* brings together ideas and examples of how the industry can solve the key issue for pensions: how to balance affordability (to sponsors and participants) with the security of lifetime retirement income. His central theme contends all the necessary tools already exist to solve the industry's challenges; the greatest current need is implementation.

   The book showcases the innovative approaches at selected leading global funds. The United States has lagged in this field, and we urge U.S. plan sponsors to read the book. In particular, we would emphasize three of Ambachtsheer's ideas that tie into the theme of the "Investors' Dilemma:"

   - Neither DB nor Defined Contribution ("DC") structures solve the affordability/ security problem in the long term; instead, Ambachtsheer suggests looking to designs for risk-sharing between sponsor and participant[3] (known as "defined ambition" in Europe or "target benefit" in North America).
   - Nobel Prize-winning economist Jan Tinbergen suggests the number of policy instruments needed must equal the number of policy goals. In the pensions context, this means that the two goals of affordability and lifetime income security require two different policy instruments. Currently the industry (especially in the United States) continues to move toward using just one (the DC plan as wealth accumulator), so a separate policy instrument is needed to address the post-retirement need for lifetime income.
   - Learn from the world's leading investment organizations. Despite differences in regulatory regimes, the concepts and issues are similar. Pension funds must align their goals, investment beliefs, organization and culture to succeed in the long term.

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4. The lead in long-term initiatives has been taken primarily by the asset owners, the large institutional investors. Asset managers may have supported the ideas, but had taken a back seat in visibility. But on February 1, 2016, the *Financial Times* story, "Top U.S. financial groups hold secret summits on long-termism" revealed that CEOs of some of the world's largest asset managers had been meeting to develop proposals for governance of public companies aimed at encouraging longer-term investment. This initiative was reportedly convened by Warren Buffett (Berkshire-Hathaway) and Jamie Dimon (JPMorgan Chase), with CEO participants from BlackRock, Fidelity, Vanguard and Capital Group. According to the article, "The asset managers hope to come up with a list of best practices that they will support at the companies they invest in" within several months.

[3]Also described as hybrid plans: see the Brandes Institute's "The Future of Retirement Plans" October 2013

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Conclusion

Pressures towards short-term investing have been mounting, and will continue. But recently, we have seen wiser heads prevailing. Leadership of the pension and investment industry is promoting genuine long-term concepts. The tools are all there. The leaders are already moving. Pension fund trustees/administrators, their consultants and asset managers can make a genuine difference in resolving the *investors' dilemma*, both for themselves and for the investment industry. It's time to step up.

APPENDIX: The S&P Long-Term Value Creation ("LTVC") Global Index

Background

On January 21, 2016, the Canada Pension Plan Investment Board ("CPPIB") announced that, along with other major institutional investors, it would invest about $2 billion in funds tracking a new global equity index launched by S&P to focus on "companies with the potential to create long-term value" (S&P Long-Term Value Creation Global Index or LTVC). The other named initial investors include GIC from Singapore, Ontario Teachers, ATP from Denmark, PGGM from the Netherlands and New Zealand Super. This launch and the related commitments are linked to the Focusing Capital on the Long Term initiative, and all six of the investors are members of that group.

Leadership of the pension and investment industry is promoting genuine long-term concepts.

The link to the press release from CPPIB is below; this was broadly disseminated in the global and trade press. http://www.cppib.com/en/public-media/headlines/2016/sp-ltvc-2016.html

The LTVC Index

Although LTCV is a stock index created by S&P, we believe its practical role for investors' portfolios will be more akin to a systematic active strategy. It was developed in part by Robeco's SAM unit (Sustainability Asset Management) in partnership with S&P. The construction process equally weights S&P's quality scores with SAM's sustainability scores, using three-year smoothing to keep turnover moderate. Constituent weights are then based on this quality/sustainability metric. Rebalancing is annual. So, unlike many ESG-related benchmarks, this is not a market cap index that excludes "deselected" companies or industries. We believe it should be considered a systematic active strategy, and it is has quite distinct characteristics, as outlined below.

LTVC Characteristics

While the LTVC is called an index by S&P, in practice its design includes active decisions, albeit ones that only require annual rebalancing. Treating the LTVC as a systematic active portfolio, it has a number of interesting characteristics and features, which can be illustrated by comparing it to the widely used MSCI ACWI Index.

LTVC is diversified, and quite effectively for its 246 constituents compared to ACWI's approximately 2,500 (as of March 31, 2016). LTVC also is quite concentrated versus the ACWI. With the top 10 stocks totaling 10.5% weight, it is not dominated by a few large companies as can happen with market-cap weighted indices. The Concentration Coefficient of LTVC is 175, meaning that its true concentration is effectively the same as if it held 175 equally-weighted stocks.

LTVC has the characteristics of an active portfolio. The Active Share of LTVC relative to MSCI ACWI is 79. This is a significant Active Share, but given the breadth of ACWI, we note the median active portfolio typically has an Active Share close to 90.[4]

[4]See the Brandes Institute paper, "Is Your Portfolio's 'High Active Share' Really High?" for more details on our median Active Share calculations for a variety of indices.

LTVC has a slight growth tilt overall and modestly higher dividend yield, but from a bottom-up perspective, it balances relatively equally between the value and growth features of its constituents.

	P/B	P/E	Div. Yield, %
LTVC	2.75	22.84	2.95
MSCI ACWI	2.00	18.51	2.67

Source: S&P and MSCI, as of 3/31/2016. Past performance is not a guarantee of future results.
One cannot invest directly in an index.

LTVC's "sustainable" is not standard ESG. Suffice it to note that three of the top 20 constituents in LTVC are tobacco companies: Reynolds American (#1), Altria (#4) and British American Tobacco (#14).

LTVC country weights differ significantly from those of the MSCI ACWI. Using a 3% difference as "significant," two countries have significantly lower weights in LTVC relative to ACWI: USA, 40.0% versus 53.2%; and Japan, 0.8% versus 7.5%. Two countries have significantly higher weights: S. Korea, 5.6% versus 1.6%; and Netherlands, 4.3% versus 1.0%. And no Italian company makes it through the sustainability and quality screen and into LTVC.

LTVC regional weights differ from ACWI

Region	LTVC weight, %	MSCI ACWI weight, %	Difference
N. America	45	57	-12
Europe	34	22	+12
Asia	7	11	-4
EM	14	10	+4

Source: S&P and MSCI, as of 3/31/16

LTVC sector weights differ from ACWI; six sectors differ by more than 3%

Sector	LTVC weight, %	MSCI ACWI weight, %	Difference
Consumer Staples	19	13	+6
Materials	10	5	+5
Industrials	15	11	+4
Healthcare	8	12	-4
Info Tech	8	15	-7
Financials	10	20	-10

Source: S&P and MSCI, as of 3/31/16

Other notable features in stock composition: LTVC has 15 U.S. stocks and five non-U.S. stocks in its top 20 holdings, while ACWI has 18 U.S. stocks and two non-U.S. stocks. But no stock appears in the top 20 of both. Of the five largest non-U.S. stocks in each index, four of LTVC's top five are from emerging markets, but only one of the ACWI top five is from emerging markets.

LTVC has a significant mid- and small-cap component. While the median market cap of $19 billion is triple that of ACWI (which has over 2,400 stocks), the top 100 stocks in LTVC include 42 with market caps below $20 billion, of which 13 are below $10 billion.

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The S&P Long-Term Value Creation (LTVC) Global Index is designed to measure stocks ranking highly in global equity markets, using both proprietary sustainability and financial quality criteria. Constituents reflect the combination of two measures seeking to gauge the potential for long-term value addition. All companies are constituents of the S&P Global LargeMidCap Index.

The S&P Global LargeMidCap Index is a comprehensive, rules-based index measuring stock market performance of mid to large capitalization companies from developed and emerging markets.

The MSCI All Country World Index with net dividends measures equity market performance of developed and emerging markets.

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Active Share is the percentage of a portfolio that is different than its benchmark index. It is calculated by taking the sum of the absolute value of the difference of the weight of each holding in the portfolio vs the weight of each holding in the index and dividing by two.

The Concentration Coefficient is the inverse of the sum of the squares of the weights of the stocks in a portfolio. Developed by the Brandes Institute in conjunction with Global Wealth Advisors, it seeks to provide a more intuitive measure of portfolio concentration by expressing concentration as an equivalent number of equal-weighted stocks.

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