

Incentivising a long-term perspective

In conjunction with the Network for Sustainable Financial Markets

Summary of discussions

1. Desirable and undesirable behaviours and characteristics

Table 1. Fund manager behaviours/characteristics

Desirable	Undesirable
Returns in line with expectations	Giving up long-term corporate performance for short-term gain (e.g. in M&A situations) ³
Sustained performance	Career risk as a driver
Asking the right questions regarding long-term performance of companies	
Less trading, more holding ¹	
Good sell discipline	
Fund managers that are doing what they said they'd do	

Table 2. Pension fund behaviours/ characteristics

Desirable	Undesirable
Monitoring risk, not performance	Employing 'short-termist' investment consultants (with a buy-list) ²
Good firing discipline ²	Quarterly discussion of performance in investment committees; sending short-term signals to managers
Patient monitoring, e.g. accept six months of underperformance if all else is well	Career risk (including trustees) as a driver

- 1 Trading versus holding: participants recognised that trading is an important market component because it provides necessary liquidity, and that measures such as strict ceilings on churn rates may not be helpful or conducive to generating the desired returns
- 2 Firing discipline: participants wanted both the ability to fire more swiftly, which in public pension funds is difficult because of the requirements of the OJEU¹ tender process; at the

¹ OJEU = Official Journal of the European Union, publication in which all tenders from the public sector which are valued above a certain financial threshold according to EU legislation, must be published.

- same time, the pattern of hiring managers at a performance peak and firing them at the performance bottom is undesirable, but is partly driven by (changes in) consultant rankings. Funds should be more willing to hold on to managers during phases of underperformance.
- 3 Cadbury's takeover by Kraft was given as an example of the focus on short-term share price movements at the expense of the consideration of whether or not the deal could deliver value in the longer-term.

2. Fee structures

- a. A show of hands revealed that all funds represented (except one) are using some form of rolling performance fees on at least some of their managers; most funds also use other measures such as rebate systems or high watermarks.
- b. There are concerns that performance fees reward luck, that they might in fact encourage short-termism, and that therefore higher management fees would be better. It was recognised that this might in turn encourage asset gathering. Management fees should cover the cost basis, but participants questioned the link to AUM, and whether the management fee shouldn't rather decrease with rising AUM, both at investor and manager level.
- c. Performance fees that are based on a separation of luck and skill might be an alternative. Some funds are using analytics' behavioural finance based method of measuring luck and skill for monitoring and engagement with fund managers. The use of such metrics to quantitatively determine performance fees has not been explored, and one participant raised the concern that this might overcomplicate things.
- d. The winning entry of the 2004 USS sponsored competition "Investing pension funds as if the long-term really mattered" suggested a 10 year guaranteed contract, small management fee, and deferred performance fee (5 years). However, this was never tested in real life, and indeed some public funds questioned their ability to do so within the constraints of the OJEU process.
- e. Difference in market regimes were flagged up: e.g. US regime may not allow deferred performance fees – if they are not paid straight away, this might result in tax implications.

3. Fund manager incentive schemes

- a. While co-investment is generally seen as the best method of aligning fund managers with pension fund interests, participants were concerned that even if a manager co-

invests, they will have their own liabilities (house, children) and own risk appetite/aversion. They will not carry the burden of the long-term liabilities of their pension fund clients. Personal liabilities might be a stronger driver than pension fund interests. It was suggested that the effectiveness of co-investment also depends on how long an individual is working with the fund (the longer the better). A partnership structure was suggested as the strongest method of alignment, because partners would care about the business. E.g. listing of a fund management business would lead to more short-termist behaviours and introduce the principal/agent problem.

- b. Some pension funds are incorporating questions about fund manager incentive schemes into the appointment process, e.g. level of co-investment. It was suggested that the level of payouts could also be an indicator for business risk, e.g. if the level of payouts to individuals is out of proportion or unsynchronized with the level of performance fee; however, this is difficult to quantify.
- c. It was noted that asset owners are patient when it comes to the private equity J curve, but not for listed equity. The PE incentivisation model might be better aligned (back-ended), but expensive to run, and while it matches the PE lock-in characteristics, it does not match the listed (liquid) equity characteristics.
- d. In terms of behavioural change LTIPs might be useful, but a three year performance period was not seen as long enough. There were conflicting views on performance drivers: for internal fund managers the competitive nature of the job might be a more important driver than the bonus; or bonuses might be the only driver and the level of payout is more important than the different performance measures/periods. One fund reported that they had started using LTIPs internally, but without extra-financial targets, and that it hasn't been around long enough to have been properly tested.

4. Governance and behavioural changes

- a. A more successful attempt to change behaviours might come from fund governance: the idea was put forward to separate trustees from fund manager performance review and let them focus on asset allocation. Pension fund staff liaises with fund managers, prepares a periodic performance report (e.g. annually) and gives its presentation an appropriate weight (i.e. less). Reference was made to the work by Keith Ambachtsheer. However, what is needed for this is a reasonable size investment team. Smaller, under resourced funds may not find it possible to implement this structure – can the bigger funds drag them along?
- b. Trustee training was also raised, to avoid trustees overreacting when there is a problem. Quarterly information is useful but it is how to react to it that is important.

- c. 'Firing discipline' – OJEU requirements are a problem for public pension funds as they do not allow quick reaction. The model 'get a 5 year contract and if it works well, you get another 3 years' for external managers does not necessarily fit in with OJEU requirements. Transition costs must be considered as a more frequent manager rotation programme will incur higher transition costs, both direct and indirect (e.g. staff workload, consultant fees etc).

5. Other considerations

- 6. The shift to DC will mean more short-termism – inherently short-term (despite inertia), and portability may lead to DC competition and therefore short-term pressures.