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HOW WE INVEST – DISCUSSION PAPER

Investment  
beliefs

# Investment beliefs

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# Investment beliefs

## INTRODUCTION

Pension fund investment operations are built around the lesser and greater choices investment decision-makers make every day on behalf of the fund. Investing is not an exact science, however, which means that the choices we make are based not just on experiential knowledge, but also on beliefs about how capital markets work in the long term. Much theoretical or empirical research typically underlies these beliefs.

It has become commonplace among institutional investors to write down their key investment beliefs. This can even be seen as a necessary pre-condition for building a successful pension fund investment operation. *(Koedijk and Slager, 2010, Clark and Urwin, 2007, Ambachtsheer, 2016)*

We wrote down our first Investment beliefs in spring 2017 at Keva. The Investment beliefs are, by nature, a concise presentation, but this paper provides more colour on our thinking behind these beliefs.

## OBJECTIVE AND RISK APPETITE

➤ **The objective of the fund is to generate real investment returns required to meet our long-term pension liabilities under the Act on Keva. This requires us to take on investment risk. Taking on investment risk might at times result in investment losses over short and medium-term horizons.**

The investment objective of a pension fund can perhaps be taken as a given. In practice, however, investment operations are from time to time up against pressure from stakeholders and service providers to operate in a manner that could be incompatible with our investment objective. With this statement, we want to emphasise the need to remain focused on the objective of long-term real returns.

Pressure to act in conflict with our objective can occur, for example, through the benchmarking of short-term pension fund returns that are quarterly published in Finnish press. Building investment operations on the basis of these "beauty contests" can lead to short-sighted investment behaviour and, consequently, weak investment results vis-à-vis the objective. *(Warren, 2014, Ambachtsheer, 2013)*

Determining a suitable risk appetite compared to the fund's liabilities, i.e. the risk to return ratio, constitutes the most important choice to be made in the fund. Since net real payments over the coming decades significantly outstrip assets of the fund, Keva needs to take on investment risk to generate adequate real returns with regard to the liabilities.

It is likely that if the risk to return ratio is too low, the fund will in future be required to raise the risk to return ratio, or alternatively, there will be pressure to increase pension contributions. On the other hand, if the risk to return ratio is too high, the pension fund will be exposed to unnecessarily high risk in the short term. In a worst-case scenario, this could force the fund to sell risky investments when risk premiums are wide.

From the perspective of cross-generational equality, it is justifiable to drive fund investment risk on the principle of adequate, yet reasonable risk appetite.

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## INVESTMENT HORIZON

› **The long-term nature of our pension liabilities and predictable cash flows enable an investment strategy aiming for long-term investment results. A long-horizon investment strategy will generate better returns than a short-horizon investment strategy since the former allows, for example;**

- **an ability to stay in risky asset classes when short-term investors are forced to sell**
- **an ability to use market pricing patiently and counter-cyclically**
- **an ability to invest in illiquid assets and investment vehicles**
- **access to asset managers and partners which are not available to short-term investors.**

› **Investment returns are driven by long-term economic growth, which must be sustainable since pensions are, by nature, long-term liabilities. Integrating the dimensions of responsible investment (ESG) into the choice of investments creates long-term added value through better returns and lower risk.**

Recent years have triggered active discussion in academic literature and among institutional investors about the importance of investment horizon as a driver of investment returns (*Barton et al., 2017, Barton and Wiseman, 2014*). The benefits of a long investment horizon are pretty obvious, but it is only in the past few years that long-termism as an investment paradigm has received empirical support (*Cremers and Pareek, 2016, Harford et al., 2016*), which supports the notion of grounding Keva's strategy on long-termism. More generally, a long horizon investment strategy can be regarded as a natural structural edge a pension fund can have in investing (*Ambachtsheer, 2016, Ang and Kjaer, 2012*).

On the other hand, the disadvantages of short-term investing are not necessarily as obvious. Literature often divides these disadvantages into two parts;

1. the friction created in investing (e.g. trading and transaction costs, herd behaviour, frequent turnover of asset managers) (*Hawley et al., 2011, Ambachtsheer et al., 2013, Stewart, 2013, Ambachtsheer, 2013, Bushee, 2001, Stewart et al., 2009*).
2. the friction caused by short-sighted behaviour of companies we invest in on the one hand and the opportunities brought about by a longer strategic horizon on the other. (*Brochet et al., 2012, Eccles et al., 2014, Khan et al., 2016, Rappaport, 2006*).

The horizons of the investor and companies are interwoven since owners steer company operations. On the whole, the disadvantages of short-termism result in significant welfare losses to society, which is why organisations such as the OECD and FCLT have called on asset owners to play a role in shaping companies' strategies and culture towards longer-term (*Croce et al., 2011, Barton et al., 2017, Harford et al., 2016, Waitzer and Sarro, 2014, Barton and Wiseman, 2015*).

We believe that the ability to invest for the long-term is a structural competitive edge for Keva.

Responsible investing is possible only if investment is long-term by nature, because ESG risks are mostly long-term phenomena. We consider responsible investing to be an integrated part of a long-term investing.

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## ALLOCATION

- **Allocation to various systematic return drivers is the key decision determining investment returns.**
- **Asset class expected returns and risks vary over time, are at least partly predictable, and typically revert towards a long-term mean.**

Allocation to systematic return drivers explains the majority of the volatility in investment returns. It is important to note, however, that the systematic factors (e.g. economic growth, interest rates, inflation) that determine investment returns do not directly follow asset category labels, but that the same factors operate in the background of all asset classes. (*Ilmanen, 2011, Straehl and Ibbotson, 2017*)

An investment portfolio is, however, ultimately built up of investable asset classes. The returns and risks offered by these asset classes have varied historically. To some extent, returns and risks can also be predicted in the medium or long term, whereas this is difficult in the short term. (*Ilmanen, 2011, Straehl and Ibbotson, 2017*)

When we start from a belief that compensation for risk varies over time, and that this risk premium is at least partly predictable, it makes sense to adapt fund's risk allocation to the prevailing situation. When markets offer small compensation for taking on risk, we reduce allocation to risk. When risk premiums are higher than usual, we increase allocation to risk. This dynamic is carried out around the long-term natural risk appetite derived from the liabilities.

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## DIVERSIFICATION AND INVESTMENT RISK MANAGEMENT

- **Diversification across return drivers improves the risk to return ratio. Investment risk is best managed at the total portfolio level rather than as a collection of individual portfolios.**
- **Investment risk is based on total risk analysis emphasising qualitative values. Quantitative analysis is one tool that is part of the overall investment risk management process.**

Diversification improves the risk to return ratio of the portfolio. An efficiently diversified portfolio allows us to achieve the same returns at a lower risk than an inefficiently diversified portfolio would. Alternatively, an efficiently diversified portfolio enables us to achieve higher returns at the same risk than an inefficiently diversified portfolio would.

Effective diversification does not necessarily come about by increasing the number of securities or asset classes in the portfolio, because the same underlying systematic factors (economic growth, interest rates, inflation) determine returns. From this point of view, we seek to manage investment risk for the fund's portfolio as a whole instead of as a collection of individual subportfolios.

Recent years have seen significant development in risk management systems and in transparency of investment products. Although the systems provide us with a better picture of the risks in the investment portfolio, even the best risk systems have significant constraints. Risk systems typically describe risk as short-term quantitative phenomena, such as a standard deviation of returns, whereas a long-term investor would require longer-term indicators. For example, ESG risks are phenomena that materialise over the long term and which quantitative risk management systems are unable to process.

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## MARKET EFFICIENCY AND ADDED VALUE

- **The extent to which markets are efficient varies across markets and over time, which allows strategies to be based on value added. Value added when uncorrelated with market returns improves the characteristics of the investment portfolio as a whole. Capturing value added requires an appropriately resourced and disciplined process.**

One of the main bones of contention in financial economics relates to the efficiency of the markets. Under efficient markets, returns offered by investments are compensation for systematic risks taken by the investor. Investing is then simplified into a decision about risk and its most effective implementation on the markets.

Market efficiency has been dealt empirically from many angles in literature. We know that actively managed funds are, on average, less successful than the market (*e.g. Fama and French, 2008*). On the other hand, however, certain characteristics related to the investment process, the investment company, and the investment vehicle seem to explain large dispersion associated with active returns (*Jones and Wermers, 2011*). Interestingly, an investment strategy oriented towards a longer horizon seems to predict positive active returns (*Cremers and Pareek, 2016*).

Liquidity premium, or compensation for locking up funds for a long time, is the one return driver for long-term investors. In many asset classes, active strategies based on added value are the only possibility to benefit from this return driver.

Total return from an investment can be divided into the market (index) return and the active return. Active returns improve diversification of the portfolio when uncorrelated with market returns.

Drivers of active returns and, therefore, the success of strategies based on active returns, are not necessarily a permanent phenomenon in time. Excessive returns attract capital and thus reduce future returns offered by the phenomenon. Because of this dynamic, we constantly review the justification of strategies based on added value.

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## RESOURCING AND COSTS

- **We seek to insource investment management in markets where we deem it is efficient given inhouse expertise. We complement insourced investment management with like-minded partners who, as much as possible, share our investment beliefs. Our work with external asset managers is based on long-term relationships, trust and transparency."**
- **Managing fees and costs is a key part of the value creation process. We assess investment performance net of all costs."**

Operationally, investing can be implemented in roughly four ways. Assets can be managed by inhouse portfolio managers, actively or passively. Alternatively, assets can be managed with the help of external managers, actively or passively. Keva currently uses a mix of these that is close to the average of an international peer group (*Ambachtsheer, 2016*).

Insourced portfolio management has many advantages, among them cost efficiency and transparency. On the other hand, local knowledge plays an important role in strategies based on added value (*Ferreira et al., 2013, Fama and French, 2008*), so the use of partners is a sensible alternative in a globally diversified portfolio.



As a rule, the use of external managers always gives rise to higher costs compared with insourcing, especially in strategies based on added value. However, the costs of outsourced solutions can be justified if net returns exceed those from insourced operations.

The use of external managers is not without its own problems, perhaps the most important of which is the so-called principal agent problem (*Neal and Warren, 2015, Ferris and Yan, 2009, Swensen, 2009*). Asset managers may have many motives that diverge from Keva's objectives. These motives include the financial interests of the persons responsible for portfolio management, the interests of the asset management company and its' owners, the interests of other clients or a different investment horizon. This being the case, we give particular attention to ensuring that our partners share our objectives and, as far as possible, the same investment beliefs as Keva.

Costs are the only certain component in investment returns and therefore require constant attention.

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