

Governance and Long-term Investing

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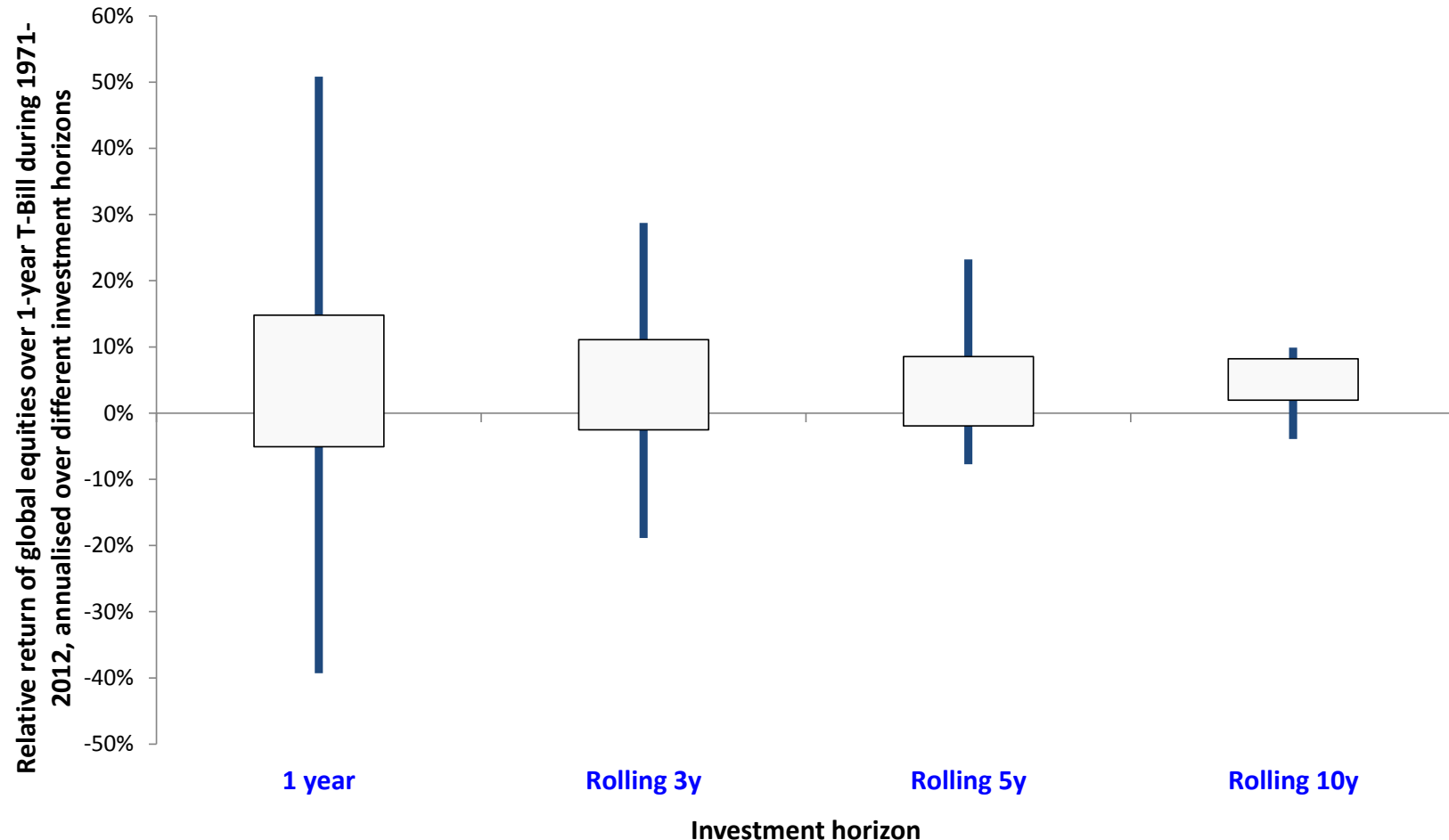
Governance frameworks and long-term investing

- The time frame over which risk premia clearly manifest themselves can be very long
 - Markets are a popularity contest in the short-term
 - Short-term pressures arise because time period is longer than most people's horizon for assessment and risk tolerance
- Good governance frameworks can help manage the tension between long-term objectives and short-term pressures

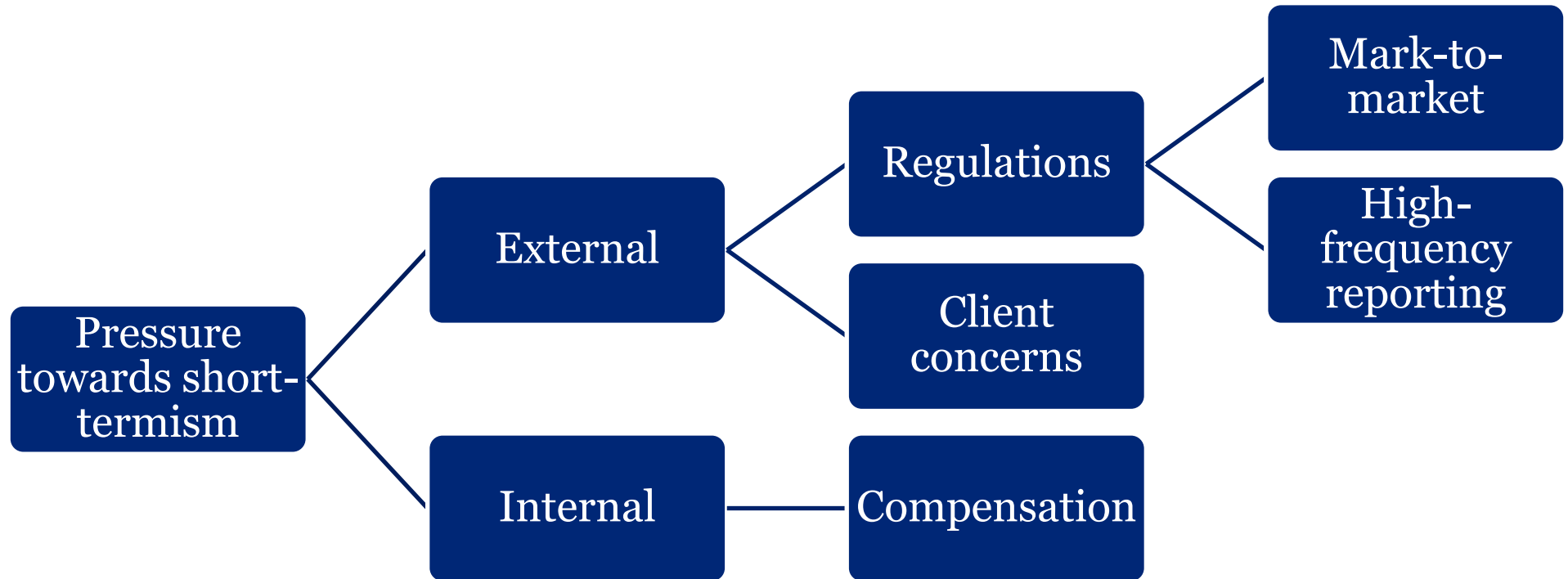
Variability of even one of the most basic risk premiums—the equity risk premium—is high over short horizons

Realization of Equity Risk Premium over varying horizons

(boxes show 1st-3rd quartile range; stick shows max-min)



There are significant external and internal pressures to avoid short-term volatility and losses



And sometimes, we tend to get carried away when we miss the big picture ...

“The eurozone has 10 days at most.”

- Wolfgang Munchau, Nov 2011

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“Suddenly, it has become easy to see how the euro ... could come apart at the seams. We’re not talking about a distant prospect, either. Things could fall apart with stunning speed, in a matter of months, not years.”

- Paul Krugman, May 2012

And sometimes, we tend to get carried away when we miss the big picture ...

“We now believe the probability that Greece will leave EMU in the next 12-18 months is about 90%, ... and believe the most likely date is in the next 2-3 quarters.”

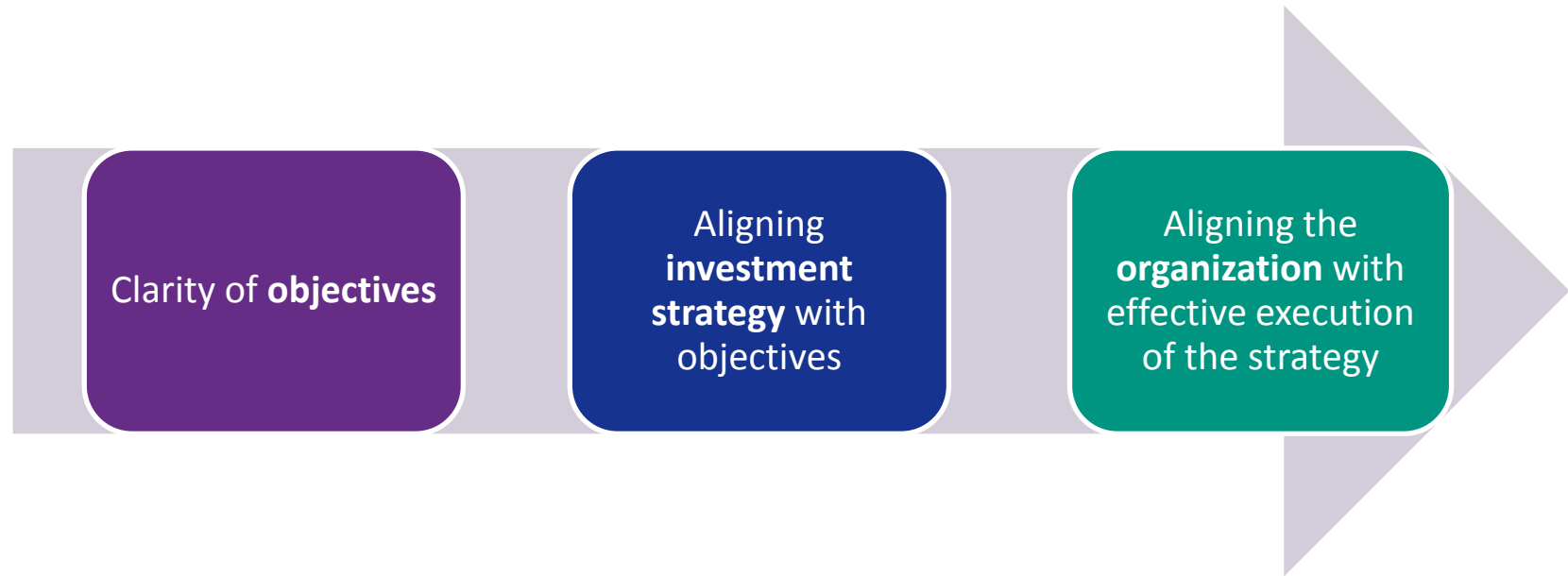
- Willem Buiter, July 2012

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A good governance framework encompasses clear objectives, well-aligned investment strategies, and an effective organization



Some elements of a governance framework that work ...

What works

- Realistic conversations over what can or cannot be achieved
- Clear statement of objectives
- Important to have clarity on client's risk tolerance.
- Clear articulation of risk premia that you expect to harvest over long-term
- Greater understanding of risk, esp. downside
- Rebalancing
- Long-term oriented compensation
- Organizational culture
- Attracting the right talent

Clarity of **objectives**

Aligning **investment strategy** with objectives

Aligning the **organization** with effective execution of the strategy

There are challenges at every stage ...

Challenges

- Getting client to clearly state objectives
- Tension between absolute and relative return mandates
- High-frequency reporting
- Balancing long-term objectives with medium-term risk tolerance
- Clarifying accountabilities for outcomes of long-horizon investments
- Balancing long-term pay against relevance for current employees

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Summary

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In volatile markets, it gets harder to distinguish cyclical from structural moves in the short-run

Number of times S&P 500 experienced a monthly decline > 5%

