Investing time horizon is a contentious issue in finance. There is rarely any consensus on what a long or short time horizon really means. One way to think about time horizon is through the lens of an investor’s objective. A young worker investing for retirement, for example, could have a 30- to 40-year time horizon, while one who is investing for a down payment on a home may have a shorter time frame in mind.

It is important to understand investors’ time horizon as it affects the kinds of opportunities they can capitalise on, the approach to investing, and the types of investments made. It can also determine how much risk investors are willing to take. The bottom line is that investing time horizon can be a big factor in setting investment objectives and shaping investor outcomes. Little wonder, then, that plenty of literature deals with the subject.

This paper highlights the core findings drawn from research on the issues surrounding investment horizon, considering them through two perspectives – that of the asset owner and the investment manager. Investing is defined here as investing in public equities and for longer-term objectives such as retirement.
An asset owner’s perspective

Being invested matters
A series of financial crises over the past 20 years – from the Asian financial crisis and the dotcom crash to the more recent global financial crisis and the Eurozone debt debacle – has dented the confidence of investors in equities as an asset class.

However, a large body of academic and industry research shows that for long-term investors, being invested in equities still trumps holding cash. Cash may offer short-term safety but the long-term downside is inflation, which can erode the purchasing power of money.

Over longer periods, equity investing has typically delivered higher returns relative to what are perceived to be safer types of investments such as cash and government bonds, albeit at a higher risk.

There are several arguments in favour of long-term investing:

- A 2011 report by the World Economic Forum (WEF) and consultancy firm Oliver Wyman points out that long-term investors are better able to take advantage of opportunities arising from secular themes or macro trends such as ageing societies and the shift from service- to knowledge-based economies.

- Long holding periods and extended time horizons tend to be associated with low costs, as they often lead to lower portfolio turnover. Moreover, buy-and-hold strategies can avoid behavioural mistakes such as buying high and selling low.

- As shareholders of an enterprise, long-term investors can reap rewards from improving corporate decision-making through engagement with companies.

- Putting money into long-term investments can provide tax advantages on capital gains in certain countries.

- Andrew Ang and Knut Kjaer in a 2012 paper suggest that the turmoil in capital markets over the last decade has increased the competitive advantage of a long investment horizon as long-term investors can capitalise on short-term mispricing during periods of greater risk aversion.

Staying invested versus timing the market
Despite the benefits of long-term investing, some empirical evidence suggests that investors continue to focus on short-term returns.

A 2014 survey of mass affluent investors (with investable assets of between US$250,000 and US$1 million) by AssetMark, a consultant for financial advisers, observes that more than half of the investors expect their advisers to adjust their investments frequently to keep up with changing market conditions.

A relevant question to ask is whether investors who time markets fare better. According to an influential study by Ila Dichev published in the American Economic Review in 2007, actual investor returns, which consider the timing of investor purchases and sales throughout the entire holding period, are consistently lower than buy-and-hold returns.

A look at new cash flow into equity funds over 2000-2014 (Exhibit 1) highlights the same issue of poor timing. Investors pulled out of equity funds in 2009, though in retrospect that would have been the best time to invest in stocks given that markets bottomed.

The WEF report estimates that long-term oriented institutional investors only allocate 25% of their approximately US$27 trillion of total assets to long-term investments. There are a few key constraints for institutional investors.
Liability profile
Many have short-term liability profiles and are unable to hold on to assets when markets turn volatile. Pension funds, for example, must service short-term obligations such as upcoming payments to beneficiaries.

Decision-making constraints
In order to execute a long-term investment strategy, they need to overcome decision-making constraints such as behavioural biases (including herding behaviour) and principal-agent concerns. The interests of the principal such as shareholders or fund beneficiaries may not be aligned with those of the agent such as the investment manager.

Risk appetite
Other hurdles include risk aversion and an unwillingness to accept short-term volatility and/or potentially sizeable losses. Some institutional investors are put into a position of having to defend a long-term strategy to their clients, such as fund shareholders and pension contributors, when a fund loses money.

Long-termism in action: GIC, Singapore’s sovereign wealth fund
It is easy to say that taking the long view is fundamental for sovereign wealth funds. The tricky part is putting the principle into practice. As Lim Chow Kiat, GIC’s group chief investment officer, observes in GIC’s Long-Term View, “one of the most difficult investment decisions to make is one that forces you to stand apart from the crowd”.

Putting long-termism into action, Lim notes, requires the entire organisation to share the same orientation. Both investment and organisational practices must be supportive. Accordingly, GIC’s investment mandates focus on the long term. The key investment metric at the aggregate-portfolio level is the return above global inflation. Within the aggregate portfolio, the minimum time horizon for performance measurement is five years.

Their organisational practices underpin their long-term approach. In hiring, for example, emphasis is on mindset fit, while succession planning is also in place. Performance evaluation and incentive systems are based on multiple time periods.

As Lim puts it, “In theory, long-termism should give investors a big edge. The reality, however, is that even investors with explicit long-term mandates find it hard to put long-termism into practice.”
Equally, sovereign wealth funds and endowments are not immune to public and political pressure to change their investment strategy, especially during market downturns.

**Regulatory pressure**

Institutions face significant pressures, including quarterly and annual reporting, which often promote pro-cyclical behaviour and limit the ability to make long-term investments. Ironically, many of these stem from efforts to improve the regulatory environment for long-term investments.

Taken together, these factors can drive rapid selloffs and the switching of strategies, as was evident during the global financial crisis, when institutions became pro-cyclical during the global financial crisis

Institutional investors tend to have long investment horizons and follow a less cyclical investment pattern. By investing counter-cyclically (buying when asset prices fall and selling when they rise), they can help stabilise markets. However, empirical evidence suggests that a lot of them view investments through a short-term lens.

During the global financial crisis, many institutional long-term investors gave in to ‘herd behaviour’, as highlighted in a 2013 paper published by the International Monetary Fund (IMF). Pension funds in some countries, for instance, were net sellers of equities. Mutual funds, too, showed rapid drawdowns after the collapse of Lehman Brothers (Exhibit 2).

According to the IMF, several factors drive pro-cyclical investments. Investors may underestimate their liquidity needs and become forced sellers when market conditions worsen abruptly. They may also find themselves exposed to risks that are difficult to define, quantify and manage in highly volatile markets.

Another contributing factor is principal-agent problems: investment managers are often rewarded for short-term performance, contrary to their clients’ long view. Short-term reporting and disclosure policies also create implicit pressure, while regulations and market convention, such as strict mark-to-market accounting rules and rigid capital requirements, can hamper the ability to weather short-term volatility.

The impact of pro-cyclical investing by long-term institutional investors can be significant. This is because institutional investors are usually large and can cause considerable market disruptions. It is also counter-productive: these actions may hurt their investment returns, rather than protect them, given that long-term investments can earn risk premiums that are difficult to achieve in the short run.
Long-Term Investing: A Prologue

with a tradition of long-term investing succumbed to pressure and abandoned their hitherto long-term stance.

**Picking winners but at what cost?**

Asset owners that shift their focus from long-term to short-term investment performance often end up hiring and firing their investment managers at the wrong time, which can destroy value.

According to a 2004 study by Amit Goyal and Sunil Wahal, many asset owners largely base their decision to change investment managers on recent performance (which is seldom predictive of future gains). The authors note that if asset owners had kept their fired investment managers, their excess returns would have exceeded those delivered by the new managers.

These findings are corroborated by investment consulting firm Cambridge Associates’ analysis of institutions from 1996 through 2001. The equity managers who were fired lagged their benchmark index by 170 basis points on average in the three years prior to the firing. They then outpaced the benchmark on average by 660 basis points in the three years following the switch. Furthermore, the fired equity managers surpassed the excess returns of the newly hired equity managers 60% of the time over the next three years.

On the whole, asset owners can make poor choices when they decide to switch investment managers. According to The Long-Term Portfolio Guide, an output of the Focusing Capital on the Long Term initiative (co-founded by the Canada Pension Plan Investment Board and McKinsey & Company), investment managers who feel compelled to match benchmarks or unrealistic expectations are also prone to make more mistakes or can ignore their best long-term ideas for fear of underperforming in the short run.

**An investment manager’s view**

**The long and short of average stock holding periods**

Investment managers, like many of their clients, have adopted an increasingly short-term mindset. One indicator is the ever-shrinking holding periods of companies in a portfolio.

A Mercer study in 2010 shows that even long-only equity managers are becoming more active. It points out that nearly two-thirds of the over 900 strategies studied had a higher-than-expected turnover. Strikingly, some recorded more than 150-200% higher turnover than anticipated.

All of this should come as no surprise. Part of the problem is the short review period of mandates relative to the full economic cycle, which encourages short-termism.

Another issue is mixed signals from clients. As one manager remarks in the Mercer report, “Pension trustees can seem concerned about the long-term performance of their funds in one room and then seem overly concerned about the short-term performance in the next office over.”

British economist John Kay writes in the 2012 Kay Review that “the appointment and monitoring of active asset managers is too often based on short-term relative performance.” That, he says, is a glaring misalignment of incentives, given that the interests of many clients, not least pension fund members, are in long-term absolute results.

Kay reasons, too, that the danger of emphasising relative performance is that asset managers become ‘closet indexers’ to avoid underperformance. Further, he calls for an end to quarterly reporting and advocates a culture of stewardship to help improve long-term outcomes.
Long-Term Investing: A Prologue

So far, there have been some hopeful signs of change; quarterly reports are no longer mandatory for public firms in the UK and Europe.

The CFA Institute goes further, suggesting that incentives and compensation be aligned with long-term performance (three to five years) and client interests. It also recommends that asset managers invest their own money so that their compensation would be directly related to the returns for fund shareholders.

Two other recommendations are: greater transparency and communication with fund shareholders, in addition to broad education about the benefits of long-term thinking.

Spot the long-term investment manager

Long-term investment managers are perhaps best characterised by their alignment with their clients’ long-term objectives

This can be through incentive structures that are compatible with a long view or investing alongside the client. In the former case, the 2010 Mercer report cites examples of managers who are evaluated against peer group rankings; or paid on the basis of team performance or longevity with the company. As for the latter, there are a lot of benefits to be gained, according to the Morningstar Stewardship Survey.

Morningstar’s studies show that fund managers who invest in their own funds produce better results compared to those with no investment. This is also reflected at the firm level: those with higher levels of manager ownership are likely to deliver superior long-term returns compared to peers with lower levels of manager ownership (Exhibit 3).

When it comes to being committed to a long-term investment horizon, culture matters

A collaborative culture, in particular, can help integrate multiple perspectives and improve risk management, while helping to mitigate behavioural biases.

Culture also shapes the way business decisions are made, including the recruitment and retention of talent.

Morningstar asserts that longer tenures suggest a stronger corporate culture and, more importantly, correspond with better long-term returns.

Long-term investment managers tend to prepare for a smooth transition of company ownership

The reason is that it ensures continuity and stability. This may take the form of owning company stock, which not only transfers ownership and leadership in a company but also reinforces long-term behaviour.

Exhibit 3: Manager ownership and better results go hand in hand

Morningstar success ratios* by percentage of firm fund assets with high manager ownership of fund shares

Source: Morningstar, Inc., 31 December 2014

* Success ratios and risk-adjusted success ratios report what percentage of an asset management firm’s mutual fund offerings have both survived and outperformed their respective Morningstar category median fund’s results over a given time period.
Long-term investment managers should have a strong focus on long-term investment outcomes

Placing too much emphasis on benchmarks potentially means losing focus on the ultimate benchmark: client goals. While benchmarks play a key role in evaluating fund returns, they have their limitations.

Relying on them to build a portfolio, for example, could inadvertently expose investors to further risk. For investments to succeed, they must incorporate investor objectives. For investors seeking income, for instance, the true measure of success becomes how well their investments meet their financial needs in a manner that is consistent with their risk tolerance; benchmark returns clearly play no part.

(Not) The last word

Much has been written about investing time horizon as it relates to asset owners and investment managers. But there is still much to be learned. For example, how do behavioural biases prevent investors from focusing on the long term? Or, what are the benefits of staying invested in periods of market volatility? The review of academic and industry literature has generated insights that will help guide our research into this subject. Our goal is to examine it in more depth in the months ahead.

Key references


