VIEWPOINT

RUSSELL INVESTMENTS RESEARCH

Are institutional investors *really* long-term investors?

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Institutional investors are long-term investors. Well, that's the theory anyway. In practice, institutional investors pay attention to several different time horizons. While the long-term matters, so does the cascade of shorter time horizons that feed into the decisions of those responsible for the management of pools of institutional assets. If there is a misalignment between the time horizon of those making decisions and the time horizon those who are monitoring the outcomes of those decisions, then disappointment is likely to follow.

In this *Viewpoint*, we expand on this idea – that there are multiple horizons to consider – and describe some of the main time horizons that matter to institutional investors. Recognizing that there are multiple horizons can help investors avoid defining either success or risk too narrowly. This, in turn, can lead to better decision-making and progress evaluation.

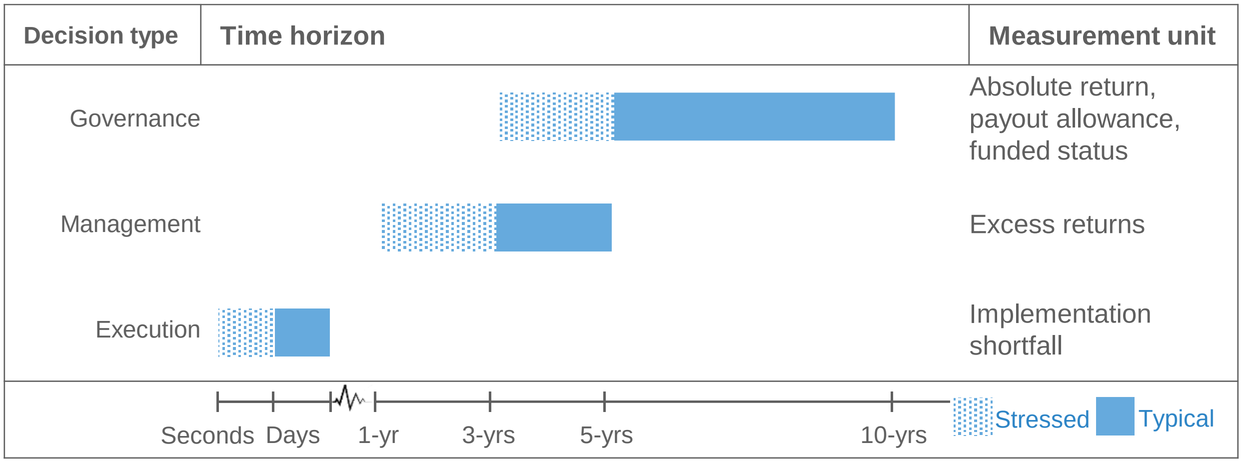
Our analysis also highlights the importance of effective communication between governing fiduciaries and investment managers, and lessons for the assessment of investment performance.

Understanding the end goal

The primary goal for the investment of most institutional assets relates to some long-term objective. Defined benefit pension plans exist in order to provide benefits to retired workers over, in most cases, decades; defined contribution plans are intended to last for (literally) a lifetime; and, for the ultimate in long-term objectives, endowments – and many foundations – may have a goal of supporting their mission in perpetuity.

So the ultimate goal to which an institutional investment program should be attuned is a long-term goal. But the bulk of the individual investment decisions that are made have shorter horizons. Whether it's the three- to five-year horizon over which active manager performance is typically judged,

Exhibit 1: A spectrum of relevant time horizons within an institutional investment program



the quarterly cycle over which portfolio performance is typically discussed, or the seconds – even the microseconds – that can matter when the underlying securities are traded, the process of making these decisions and assessing their outcomes is generally based on a shorter period than the ultimate time horizon for the organization. Different time horizons are important for different roles within the investment program, and no particular time horizon is necessarily static.

We will look at two main categories of decisions – governing-level and managing-level decisions – and touch briefly on a third: execution decisions. *Governing-level decisions* relate to program oversight, typically by a trustee board or an investment committee. These include setting the strategic policy and establishing guidelines for running the program. *Managing-level decisions* are the day-to-day investment-management decisions made by investment staff or portfolio managers (whether internal or external). *Execution decisions* concern implementation of the managing-level decisions – i.e., trading.

The interaction of these various time horizons is illustrated in Exhibit 1.

Governing-level horizons

An institutional investment strategy typically relies on a variety of sources of return – e.g., the equity return premium the illiquidity return premium, active management premium, and so on. Those premia are expected to be realized over time, but not in every quarter or every year. So a longer time horizon will likely enable a wider range of return sources to be accessed, and lead to a higher return expectation.

At the governing fiduciary level, the primary objective may b expressed in terms of decades or even longer, as described above. For practical decision-making purposes, however, that very long horizon is usually shortened.

For example, strategic asset allocation policy – arguably the clearest expression of the risk tolerance of the key stakeholders – may be based on analysis of the potential risk/reward trade-off assessed for a 10-year horizon. That analysis would generally look not only at the outcome at the end of that 10-year horizon, but also at the range of possible paths the portfolio might take to get there. For example, corporate pension plans may look at the potential negative impact of market volatility on the corporate financial statement over periods as short as one year (see callout box #2), and non-profit organizations may consider how large are the capital drawdowns that can be expected, regardless of the time period over which they occur. In both cases, being able to survive the ups and downs over sub-periods is just as much a part of the objective as achieving a good outcome at end of the full 10-year horizon.

Consider, for example, the past dozen years or so, a period during which U.S. stock market returns have been overall strong; the Russell 1000® Index returned an annualized 9.4% from the start of 2003 through the end of November 2015. In that time, only one calendar year (2008) delivered a negative return on the U.S. stock market, and investors who remained fully invested recovered 2008's losses in little more than three years. But far from being simply averaged into the longer-term picture, the experience of 2008 changed investors' perceptions of risk and continues to affect decisions today.[i]

CASH FLOWS

Cash flows accentuate the distinction between the experience along the way and the overall average return experience, with the result that the short-term pattern of returns becomes even more important. For example, if there is a cash outflow after a negative return, then an even-higher subsequent return on the remaining assets is required in order to make up that loss. This highlights the difference between ending wealth (which you can spend) and annualized time-weighted returns (which do not necessarily lead to economic value). On occasion, the timing of the good or the bad years can be more important even than the long-term average return.

In cases of decisions made for the purpose of hedging risk (such as liability hedging by pension plans, or currency exposure hedging, or downside protection), the along-the-way experience may even become the primary focus of the decision.

An assessment of whether the overall strategy has been successful is possible only over longer horizons. Over the short term, more attention will typically be paid to returns relative to the policy allocation benchmark, i.e., to market-relative performance. Even over the long-term, achieving the ultimate objective will be contingent on what is available from the markets; so, market-relative numbers may continue to be monitored, even though the overall program objective is the ultimate benchmark over the long run.

While the time horizons associated with governing-level decisions tend to be medium- to long-term, there are occasional exceptions to that general rule. For example, if a defined benefit pension plan is in a situation where a short-term decline in funded status could have immediate negative consequences, that circumstance may demand governing-level action focused on protecting the short-term position. Similarly, the investment time horizon may be temporarily shortened if a large change is planned, such as the buyout of a significant portion of plan liabilities with an insurance company.

To the extent that turnover in the membership of the board or investment committee may reduce the ability to ride out the ups and downs, that may become another factor influencing the effective time horizon.

In summary, governing fiduciaries should be looking to the ultimate goals of the program, but the relevant time horizons they will be considering in their decision-making and monitoring of the program will generally be much shorter than the decades or more for which those ultimate goals might extend.

Managing-level horizons

Managing fiduciaries – those charged with day-to-day management of the assets – face a different set of considerations than the governing fiduciaries, and they work with a different set of time horizons.

Typically, managing fiduciaries (such as investment staff or external money managers) have a mandate that is expressed relative to some market-based benchmark. (Although with the growth of Outsouced Chief Investment Officer (OCIO), there is some realignment of who, exactly, might do what: see callout box #3.) A large part of the managing fiduciary role lies in managing a trade-off between the expected payoff from taking an active position away from the policy benchmark, and the risks associated with that active position.

The nature of the positions that might be taken by portfolio managers varies greatly, as do the time horizons associated with the positions. Consider, for example, decisions around factor exposures, or "smart beta." At the long end of the factor spectrum are positions based on views about, for example, an exposure to illiquidity, small cap, or value, all of which are regarded by many investors as value-adding exposures, albeit exposures requiring longer time horizons. At the other end of the spectrum are positions based on short-term dynamics, such as momentum- or trading-driven hedge fund strategies, exposures from which the hoped-for return premium is short-term in nature.

The performance of portfolio managers is, of course, very closely watched. It is common (but not universal) for the primary measurement horizon to be set at three to five years: a compromise between the governing fiduciaries' desire for close oversight of this critical function and the need to reflect the expected payoff horizon of the positions taken within the portfolio. Performance is, however, closely tracked from day one. The base unit of measurement is generally monthly, and the numbers might be discussed (for example, at an investment committee meeting) every

THE IMPACT OF REGULATION ON TIME HORIZONS: THE EXAMPLE OF CORPORATE DB PLANS

Time horizons for institutional investors are influenced by the regulatory contexts in which the institutions operate. The corporate defined benefit pension plan experience is especially complex in this regard. For example, the amount of the sponsor's minimum required cash contribution is heavily influenced by legislative inputs such as the stabilization of interest rates, which all but eliminates the potential for any immediate impact from interest rate movements. If minimum required contributions were the only regulatory consideration, this stabilization would serve to lengthen the investment time horizon. However, corporate accounting for pension expense has a different (and rather complex) calculation methodology, a focus on which would (at present) lead to a shorter time horizon than that resulting from a focus on cash contributions. For those corporations (a minority) who mark actuarial gains and losses to market in the corporate earnings statement, the investment experience of the pension plan and the impact of changes in interest rates feeds through to the income statement each year.[ii] And the surplus or shortfall in the corporate balance sheet is always marked-to-market.

Time horizons in liability-driven investment (LDI) programs are also affected by features such as liability-responsive asset allocation glide paths (which adjust asset allocation policy in response to funded status) or pension risk transfer activity (such as lump-sum payments or annuity buyouts.)

quarter. In theory, a manager may benefit from being able to take a longer view than the three years typically afforded, but – except in private asset classes – that longer time horizon is rarely granted. The three-year horizon is, in practice, reset every 12 months, making the primary reporting cycle an annual one.

A shared understanding among those making the day-to-day decisions (the managing-level fiduciaries) and those overseeing them (the governing-level fiduciaries) is essential. What is expected of the portfolio managers, the approach to be taken toward achieving the portfolio goals, and the time horizons required to give that approach an adequate chance to succeed – all of these need to be made clear. A robust attribution/review process and clear guidelines can help to create this shared understanding. The better the communication among the portfolio managers and those who oversee them, the more likely it is that appropriate decisions will be made.

In summary, at the portfolio management level, just as at the governing level, there are multiple time horizons that apply. It is important that the expectations of those working at this level and of those who oversee them are aligned.

OCIO

In this paper, we have separated decisions into three separate categories according to who makes them, rather than according to the nature of the decisions ("strategy" vs. "timing" vs. "implementation," for example) or the length of the time horizon. Which decision falls into each category varies among investors, and varies over time as well.

One notable current trend among institutional investors is a general move toward more outsourcing, often referred to as OCIO. Certain decisions – most notably, approval of the strategic asset allocation policy – need to be retained by the asset owner, but the list of responsibilities that can be delegated is long, potentially ranging from administrative functions such as managing committee agendas, to selecting underlying managers, to conducting operational tasks such as rebalancing the portfolio.

To the extent that OCIO mandates comprise a greater proportion of the strategic decisions with long time horizons, the overall tenor of the mandate becomes longer-term than in a more traditional portfolio management function. That said, delegated decisions are typically given shorter time horizons than is applied to the decisions that are retained.

Measuring success

It is important to note that – especially at the governing and management levels – the horizon for measuring success will in practice be shorter than is really necessary for numbers alone to tell the whole story. A 10- or 20-year assessment period for judging the overall success of a given strategy is such a long horizon that it may have next to no practical application – and yet, it is actually a shorter time than would be required for institutional investors to know whether their assumptions were realistic. Likewise, the mathematics would point to allowing a longer horizon for the assessment of portfolio performance (enough time for short-term fluctuations in the numbers to even out) than is practical to give.

When performance disappoints (as it inevitably will at times), it is also important to understand why this has occurred. For example, a slow, steady record of underperformance will usually be interpreted as a sign that the chosen strategy is failing to deliver on its return proposition. On the other hand, a sharp but severe loss of value is more likely to mean that the risk proposition was miscalibrated. An appropriate reaction to such an event will depend on circumstances: Are market conditions unusual or distorted? Is the rationale for the investment positions still sound?

In other words – as all institutional investors are aware, the assessment of performance results requires judgment.

Execution-level horizons

Although they are not the primary focus of this paper, a mention of execution-level decisions is necessary to round out our overview of relevant time horizons. The execution of trades in order to carry out decisions made at the portfolio management level or (occasionally) at the governing level typically works within a much shorter time horizon than we have considered so far. Indeed, as Michael Lewis brought to the world's attention in *Flash Boys* in 2014[iii], the time horizon for trading activity can sometimes be measured in microseconds.

Not every trading horizon is short, however. Complex portfolio transitions (such as large moves between asset classes) can run to several days or, in the case of illiquid portfolios, even stretch across several quarters.

The key trade-off that underpins most trading decisions is between opportunity cost and market impact: trade too slowly, and you take the risk that prices will move against you; trade too quickly, and you may find yourself *causing* those unfavorable price moves. For this reason, trading success is generally best measured by use of implementation shortfall – the measure of how closely the final portfolio value compares to the notional portfolio value that would have resulted if the execution of portfolio management decisions had been accomplished immediately and at no cost. This approach provides a clean, clear goal for trading decisions, consistent with the higher-level decisions made at the portfolio management and governing levels.

Conclusion

The title of this paper raises the question of what is the real time horizon for an institutional investor. The short answer to that questions is: There are several. Ultimately, the success or failure of the investment program should be judged over a very long period – perhaps even in perpetuity. But, in practice, there are many waypoints over the course of the journey. So the time horizon for which many decisions are made will be shorter, even though that can reduce the potential to generate returns.

The dominant drivers of market behavior are different over a time horizon of 30 seconds than they are over a time horizon of 30 days, and different again over a time horizon of 30 years. For example, considerations that are important to a trader – such as circuit breakers or resistance levels – are of no relevance in the strategic planning process. For this reason, different tools and processes tend to be used for decisions in the strategic planning function, the portfolio management function and the trading function.

From a practical standpoint, there are three things investors should keep in mind:

1. There can be multiple time horizons, depending on the decision being made or evaluated.
2. In practice, typical time horizons are never long enough to allow the numbers to tell the whole story. There will always be an element of judgment required.
3. Good communication and alignment are essential. For example, a governing fiduciary with a three- to five-year time horizon and a steady focus on quarterly returns coupled with a manager who takes positions that typically require a five- to seven-year horizon to pay off is a recipe for disappointment.

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[i] That it has done so is probably an illustration of the principle that the experience of risk is quite a different thing from the anticipation of it. The generation of investors who personally experienced the global financial crisis will most likely continue to be influenced by those events for the remainder of their careers.

[ii] Although generally in the statement of other comprehensive income, rather than the statement of profit and loss.

[iii] Michael Lewis (2014) *Flash Boys: A Wall Street Revolt*. W.W. Norton & Company.

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