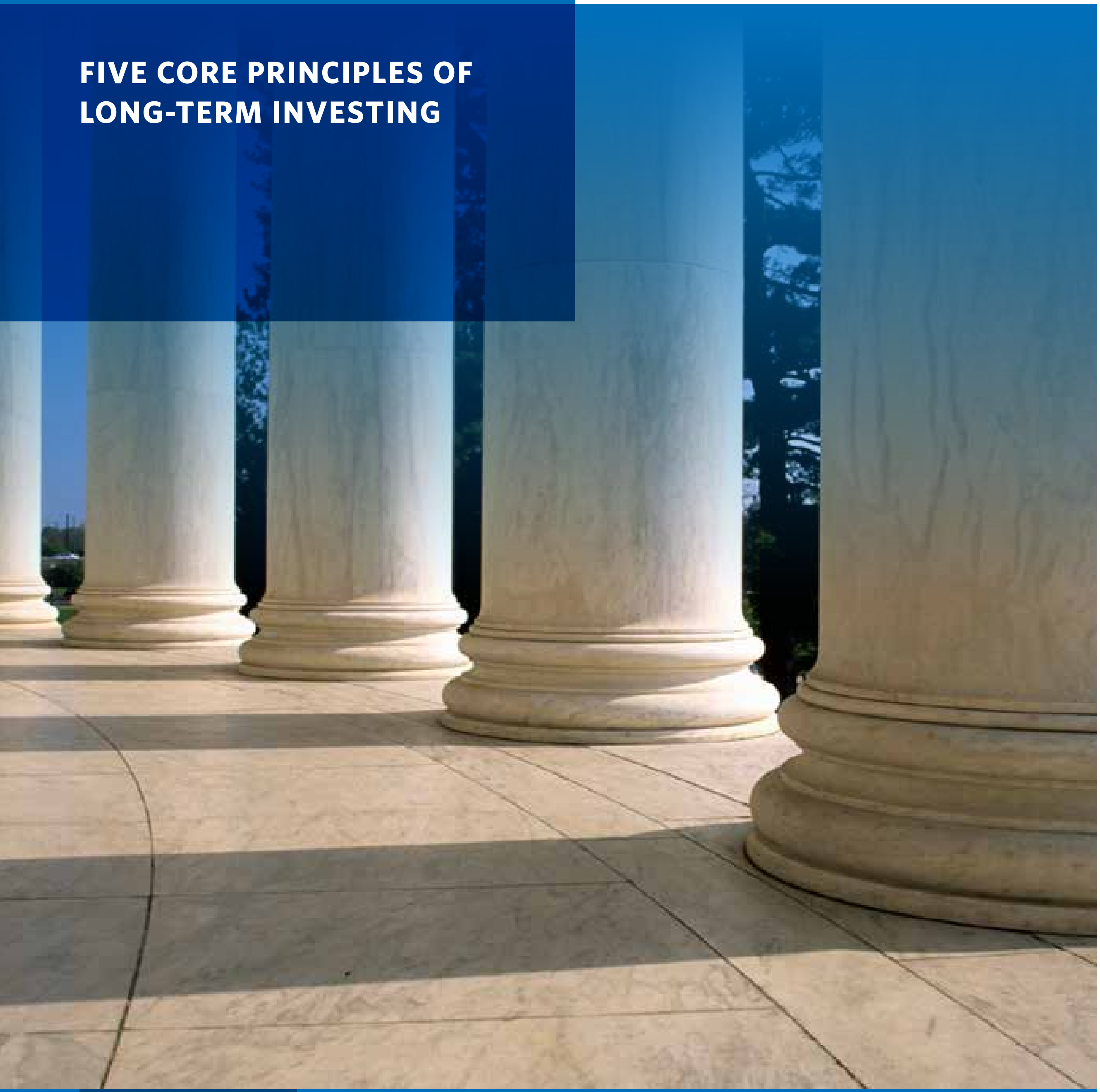
FIVE CORE PRINCIPLES OF LONG-TERM INVESTING



Strategic Investment Group®

Fiduciary Insights

SOUND INVESTING PRINCIPLES CAN PROVIDE GUIDANCE DURING MARKET UPHEAVALS, HELP MAINTAIN POLICY DISCIPLINE, AND WARD OFF THE TEMPTATION TO FOLLOW ILL-FOUNDED TRENDS. This paper presents five useful tenets.

Introduction

Sound investment governance practices are an oft-neglected, but critical element of successful institutional investing. Without them, sophisticated analysis and wise judgements can be cast to the winds on impulse. We have tried to correct the neglect of good governance through a number of *Fiduciary Insights* publications that set out our views on key investment practices.

For example, we developed a "governance quiz" entitled, "Developing a Culture of Good Governance: A Self-Evaluation Approach." As we explained in the introduction to the quiz, "A culture of good governance is based on the shared objectives, mutual respect, judgement and experience of the group of people working together to fulfill fiduciary responsibilities. Developing and sustaining a supportive governance culture takes commitment, integrity and a degree of self-awareness." It was our hope that the act of taking the quiz would stimulate the reflection and discussion that foster a culture of good governance.

This edition of *Fiduciary Insights* explores selected core principles of good investment governance.

First Principle: Aim for Success. Prepare for Failure. Promote Reasonable Expectations for Each.

Investment governance is a process of building consensus about strategies likely to succeed on average over the long run, but certain to fail painfully and unpredictably from time to time. A sound governance structure prepares for the inevitability of periodic failure and ensures that actions taken at times of stress do no harm. When good or bad tail events occur (and they occur with higher frequency than we would like), functional processes and constructive consensus tend to break down.

The probability of a breakdown increases if care has not been taken previously to nurture a culture of good governance. In particular, it is critically important to undertake thorough risk analysis that considers a range of outcomes, good and bad, prior to the adoption of an investment policy. A serious consideration of the impact of large market swings on the institution's broader finances can pay important dividends by reducing the likelihood of counterproductive knee-jerk reactions to tumultuous markets. Without such analysis, fiduciaries may drop carefully balanced strategies in favor of the flavor of the moment when markets are booming, or abandon them to go to cash when markets are collapsing, only to pay the price in terms of opportunity cost or real loss when markets return to equilibrium.

Without the core principles, sophisticated analysis and wise judgements can be cast to the winds on impulse.

Making decisions on managers by focusing on past performance is tantamount to driving a car with your eyes glued to the rearview mirror.

Second Principle: Avoid the Primitive Urge for Certainty in a Probabilistic World. Focus Instead on Valuations.

Investors tend to underestimate risks and potential losses, especially the probability of really bad outcomes. They prefer the sure thing, and may fall victim to a collective memory loss related to past crises. Such herd-following behavior is often magnified during times of ebullient markets and can lead to extravagant and unsustainable asset valuations. Examples of such behavioral failings are many; consider a few examples.

- The Japanese equity market rose seemingly inexorably in the late 1980s, pushing its market capitalization to absurd levels and distorting capitalization-weighted indices used as benchmarks by investors in international equities. Many investors followed this trend, to the point that Japanese equities came to represent 43.0%[1] of the global equity market capitalization. Today, following a prolonged and spectacular fall from grace, the Japanese market represents a mere 8.2%[2] of global equity markets.
- Such folly was repeated during the U.S. tech bubble of 1998-99, during which many tech stocks were valued more on aspirations than fundamentals.
- Today, valuations are distorted in part by government intervention against the backdrop of an anemic economic recovery. Yields on U.S. Treasuries are at extremely low levels, and their price is distorted by extensive Fed purchases and holdings. Yet investors still flock to U.S. Treasuries seeking a safe haven, despite their rock bottom yields and unattractive valuations.
- Another contemporary example is gold, whose price has been bid up to all time highs in a vote of no confidence in fiat currencies. Yet there is no metric to measure whether gold is fairly valued, no cash flows or expected earnings from gold to be discounted. As with paper money, the value attached to gold is largely a social convention.

Investing in an overpriced asset is the most dangerous and undiversifiable of all risks. This is true even if the asset—for example, U.S. Treasuries or gold—is sold as a hedge against risk. Investor, be price-sensitive! An expensive hedge is not worth having.

Third Principle: Don't Indiscriminately Kill Losers. Diversification Means Diverse Returns.

The consulting industry has prospered for many years by promoting new manager searches to replace underperforming managers. As we outlined in our first *Fiduciary Insights*, "Common Symptoms of Poor Governance," this manager-centric approach pays too little heed to the total portfolio and how different assets, managers and strategies complement each other. Moreover, making decisions on managers by focusing on past performance is tantamount to driving a car with your eyes glued to the rearview mirror and leads to a buy high, sell low strategy.

In contrast to the manager-centric approach that would seek to have every manager always performing well, we become concerned when our portfolios are hitting on all cylinders. That is because we know that well diversified portfolios should not behave that way. In a carefully diversified portfolio, some assets and managers should do poorly

1 Peak as of December 1988.

2 As of August 22, 2011.

when others are doing well. Having a portfolio hit on all cylinders suggests that it might have a potentially destructive concentration of exposures lurking beneath the surface of apparent diversification. Taming the risks of concentrated portfolios requires tolerating divergent return behavior, which includes having diversifying portfolios lose money from time to time. In fact, if you are equipped with robust fair pricing models and basing decisions on fundamental valuations, it is often advisable to invest in losers, rebalancing portfolios in order to capture the wonderfully fulfilling rebound when asset prices return to the mean.

But this begs the question, "When do you then fire an underperforming manager?" The answer is as complex as it is simple: Move away from the asset class or manager style that is no longer priced to deliver forward-looking expected returns as a result of structural economic changes or extreme valuation levels; and terminate the manager that has lost its own sense of direction and discipline. If the issue is in doubt, it is often better to spare the manager than spoil the portfolio's chances of benefiting from a rebound in prices and returns.

Fourth Principle: Think Creatively, Insightfully and Independently. Do Not Follow the Leader Off a Cliff.

We have been managing assets as dedicated fiduciaries for our clients for over 25 years and have seen how best practices also rise, according to the old Peter principle, to their level of incompetence. People and investors, like Mae West, seem to believe that "too much of a good thing is wonderful." Too much of a good thing can be just that, and is potentially very dangerous. One has to know when to stop following the fast crowd with the best idea.

For example, in 2006, we started warning of the risks of illiquidity in some institutional portfolios that had been designed by investors who were enamored with the so-called endowment model. These portfolios sought a perceived premium on illiquid investments and loaded up on them as a means of generating outsized returns. The leaders — large prestigious university endowments — garnered an avid following. Sadly, following the leaders resulted in portfolios that were insufficiently liquid to rebalance in response to large market swings. Careful risk analysis based on realistic expectations of failure (see our First Principle above) and scenario analysis would have uncovered the risk of severe bottlenecks in the payment and rebalancing processes — the result of too much of a good thing. Although we were among those cautioning about the risks of loading up on illiquid investments, many fiduciaries followed the leader off a cliff and are still reeling from leveraged commitments to illiquid assets. Many endowments, to this day, would be unable to meet outsized capital commitments to private equities and other illiquid investments if they were called at once, without significantly distorting their portfolios.

Fifth Principle: Ignore Peers. Peers Will Not Bail You Out When Your Portfolio is Sinking.

A few years back we called attention to the need for differentiation among institutional investment portfolio policies (our *Fiduciary Insights* article entitled, "Birds of Many Feathers"). Now, there are significant policy divergences even among institutional peers, and rightly so.

In the case of many sponsoring institutions, pension, endowment, and foundation portfolios are large relative to the overall finances of the sponsor and can have a significant impact (good and bad) on the financial health of the institution. Portfolios can no longer be managed with a single-minded focus on return optimization, seeking an efficient trade-off between expected investment return and risk. Rather, these portfolios must now also be managed to strike a careful balance between risks and their potential impact on the sponsor's overall financial health.

Sponsoring institutions differ significantly in many fundamental respects. Their operating income derives from different sources, the structures of their balance sheets vary, they have widely disparate prospects for the future, and their cultures and goals are unique. So why should their investment portfolios be the same? Investment policies need to be developed with an understanding of the multiple impacts of the expected range of investment outcomes on the health of the sponsor as well as other stakeholders and beneficiaries. If the unique features of the sponsor are ignored, the risk of failing to observe regulatory and fiduciary objectives increases. Comprehensive asset and liability management, which assesses risk across the sponsor's full set of assets and liabilities, is essential. Investor, know thyself, before you look to others for comfort or guidance!

Strategic Investment Group

Strategic, a pioneer in dedicated Outsourced CIO (OCIO) solutions since 1987, offers a comprehensive service platform for managing customized portfolios for institutional and private investors. Our proprietary process combines active portfolio management, rigorous risk management, and open architecture manager selection.

Strategic functions as our clients' investment partner and co-fiduciary, effectively becoming an extension of their resources. Clients are then free to focus on their core businesses, while we focus on providing the highly specialized portfolio management expertise that clients need to meet their investment goals. Depending on a client's needs and preferences, Strategic can orchestrate the management of an entire portfolio comprising multiple asset classes, focus on specific asset classes, such as alternatives (e.g., hedge funds, real estate, and/or private equity) or international investments, or manage strategies with high potential for adding value (e.g., portable alpha through investor-friendly turnkey structures). Customized liability-driven investing (LDI) solutions, whether through an integrated total portfolio approach or a targeted long-duration strategy, are also available, as are solutions that address mission-related investment objectives.

We strive to build enduring partnerships with our clients by strengthening their investment programs through a dynamic, value-enhancing investment process, sound governance framework, and world class client service. Our mission is to empower investors through experience, innovation, and excellence.

For more information, please email us at inquiries@strategicgroup.com.

Strategic Investment Group®

1001 Nineteenth Street North
16th Floor
Arlington, VA 22209 USA

+1 703.243.4433 TEL
+1 703.243.2266 FAX

strategicgroup.com