PERSPECTIVES ON THE LONG TERM

Building a Stronger Foundation for Tomorrow

GIC's Long-Term View

For Singapore's sovereign-wealth fund, taking the long view is fundamental.

by Lim Chow Kiat

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GIC's Long-Term View

For Singapore's sovereign-wealth fund, taking the long view is fundamental.

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In Singapore, long-termism is our national ethos. A willingness to forgo short-term gratification and keep faith with the fundamentals has served us well. It has been at the heart of our mission since the beginning of GIC, which was created out of a need to manage the precious savings that were set aside from limited financial resources in the early years of Singapore. As Dr. Goh Keng Swee, the former deputy chairman who conceived the idea of GIC, put it then, "There is no real secret about the way in which most nations and individuals grow rich. They must save a good part of their income, wisely and profitably invested. The more you save and the more wisely you invest, the faster you get rich."

GIC was set up in 1981 to benefit from that perspective. Specifically, GIC's mission is to invest for the long term so as to generate a good return over and above global inflation. Three decades later, GIC's performance has indeed benefited from a long-term perspective. Our investment return gained substantially from the compounding of returns, the patient harvesting of long-term risk premiums, the countercyclical rebalancing of our portfolio, the ability to take advantage of short-term dislocations in financial markets, and our long-standing relationships with many investees, external fund managers, and other partners. Enduring the short-term uncertainty, and occasional short-term pain, has paid off.

Over the years, we have learned that it is actually not the time horizon that matters most, but rather the mind-set and discipline to consistently invest based on fundamentals. In particular, it is important to have the ability to assess value and maintain price discipline in the face of market fluctuations and uncertainty. Having a long time horizon enhances this ability, especially in a world full of short-term investors. Professional investors like to bank on skill rather than luck. At GIC, we add long-termism to our formula.

INVESTING

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. In our experience, the organization's entire "ecosystem" must have a long-term mind-set for it to work. Both investment and organizational practices need to be supportive. From clients to employees, from front office to back office, and from internal investors to external managers, we try to ensure that long-termism permeates our practices. We break the necessary discipline down into five areas: the investment philosophy, governance framework, investment mandate, organizational practices, and communication.

1. INVESTMENT PHILOSOPHY

At the heart of GIC's investment philosophy is our value discipline. We look for the compounding of fundamental value and opportunities in price-value divergence. Both require a long-term orientation. We are also mindful that long-term investing does not oblige us to buy and hold for long periods. The holding period depends more on price and value than time. At the same time, while we obviously prefer market prices to move up quickly to reflect our assessed valuations, we are prepared to wait longer for the convergence than most investors.

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Translating this philosophy into practice requires constant, concerted effort. We start with an articulation of our investment principles, which we vigorously promote through multiple channels and constantly assess to make sure they drive our decision processes.

In our experience, it is more difficult to do this in the area of liquid markets. Real-time market prices, while useful for some purposes, can severely interfere with the long-term investor's discipline. The emotional Mr. Market, as master investor Benjamin Graham referred to the gyrating stock market, visits constantly to challenge that long-term philosophy. He tempts you to sell a profitable investment with a quick (but often small) gain and pressures you to sell a losing investment, even when the long-term prospects are good (and indeed may have become better because of the lower price). Short-term price swings, rather than careful judgment on fundamentals, could end up dictating investment actions.

Even more insidious, knowing that Mr. Market is always available as a way to quickly and easily exit an investment can tempt you to relax the necessary due diligence. The false comfort of a liquid market may weaken the rigor required. It is therefore critical to create an investment process that forces you to stick to a value discipline, which includes assessment rigor, a target buy list, premortem analysis, rebalancing, and monitoring of portfolio turnover, among other measures. Having the mind-set to look beyond marked-to-market prices and instead at fundamental developments in the assets has proved useful for this purpose. In equities, for example, it is critical to look beyond stock prices to actual business performance. When done well, this is a source of competitive advantage, given how rarely investors take such a disciplined approach. In recent years, we have also extended the advantage into the area of providing bespoke capital for investees. Our long-term and flexible capital has added to our opportunity set.

One of the most difficult investment decisions to make is one that forces you to stand apart from the crowd. In fact, the largest investment losses tend to arise from procyclical decisions. "Marked to peers" can be a powerful (and damaging) psychological driver of such flawed decision making. As the veteran investor Howard Marks puts it, "looking wrong" can destroy careers in most organizations. Yet the ability to make those difficult decisions is an important part of successful investing. That is why a clear articulation of a value discipline and long-term orientation is so important.

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2. GOVERNANCE FRAMEWORK

A willingness to wait for the fundamentals to eventually play out does not mean there is no need for checks and balances. Assuring stakeholders that our portfolio is managed according to our mandate is essential. We have a "no surprises" policy, which means we are proactive in raising issues relating to risks and future challenges as a way of building and maintaining the confidence of our clients and board of directors.

Our governance design also addresses potential agency problems through clear approval authority, regular reporting, and separation of conflicting roles. At the board level, there are several committees to oversee such critical areas as investment strategies, risks, active management, audit, and HR practices. To ensure that we keep an eye on the really long horizon, we also have an advisory board that examines trends that span multiple decades, for example, new technologies and demographics.

In addition to avoiding conflicts of interest and ensuring that we look out for long-term developments, we pay particular attention to equipping various levels of authority with the necessary resources. This is particularly important as GIC's operations become more complex, requiring a greater in-depth understanding of issues. Hence, for a number of years, we have benefited from the services of several experienced investment practitioners who have shared their insights and networks in a variety of areas. For example, they gave us many useful ideas when we were working on a new investment framework two years ago. They also serve as experts in different domains and countries, rendering valuable help when we need additional assessment.

3. INVESTMENT MANDATE

Whether it is our client's mandate to us or our mandate to external managers, we look for clarity. Clear statements on the return objective, risk capacity, and scope of authority give fund managers the confidence to construct the best portfolios for delivering sustainable results. In particular, the appropriate time horizon for evaluation should be discussed and agreed on up front.

GIC manages Singapore's reserves on behalf of the government. The government's investment mandate to GIC is to preserve and enhance the international purchasing power of the funds over the long term. That directive is set out clearly in an investment-management agreement with GIC.

At the aggregate-portfolio level, the 20-year-rolling real rate of return—that is, the return above global inflation—is the key investment metric for GIC. Within the aggregate portfolio, we have a policy portfolio comprising several asset classes and an active portfolio made up of several active strategies. Each portfolio and strategy, at every level, has a clear set of objectives, including a return objective, risk capacity, and scope of authority. The minimum time horizon for performance measurement is five years. In addition, we work hard to prepare expectations for potential return paths. This is to avoid surprises and allow our investors to act in a long-term manner.

We would like to adopt the same approach with more of our external fund managers, including granting longer-term lockups in return for better performance and more favorable terms. Unfortunately, we are often hampered by the fact that most other investors do not have a similar time horizon. Their need and desire to have redemption liquidity make it difficult for us to structure long-term

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mandates. This is an area where long-term asset owners could work together. In some cases, the reluctance of external fund managers to provide ongoing process visibility also poses a problem, as long lockups require us to validate performance regularly.

4. ORGANIZATIONAL PRACTICES

As in any organization, the culture at GIC emanates from the top. Senior management takes every opportunity to advocate the importance of a long-term approach. Besides regular public articulations of this, we demonstrate resolve through our decisions in human-resource practices, resource allocation, and other business areas. We want to ensure that there can be no doubt about our seriousness regarding these issues.

We emphasize long-termism in career development. In hiring, we consider mindset fit and career runway; in development, we provide opportunities for exposure to different parts of the business, and we increase responsibilities to extend the career runway; in exiting, we do extensive succession preparation and work to expand our alumni community. Our human-resource practices focus on making GIC one of the best places in the world to practice long-term investing.

It sounds like simple common sense to say that successful long-term investors must be evaluated and rewarded based on their long-term performance. Although it is obvious, it is sometimes harder to implement than you might think. First, long-term investors are often in competition with other employers that offer short-term incentives. While we believe that our total value proposition is superior, we must be careful not to stray too far from the typical employment package. This partly explains our practice of using multiple time periods to measure performance. Doing so also helps to ensure that process goals or interim targets are also met and reduces the likelihood of someone becoming too passive after a difficult start.

In addition, effective performance-evaluation and reward systems must go beyond an extended evaluation horizon. Several other elements are necessary.

Differentiating process from outcome, especially for interim results. When two investors produce the same outcome, it tells us little about who has done a better job. We ask what role process and luck played in the outcome. We also ask how much risk, and what sort of risk, was incurred. We believe you can only control the process; the outcome is simply a consequence of that process.

Evaluating performance at the total portfolio level rather than at the component level. There is often great temptation to focus on selective results. While that is useful for understanding the whys and hows, the overall result is more important.

Our incentive scheme closely follows the output of the evaluation. If the evaluation is done well, the incentive will be right.

5. COMMUNICATION

There are two aspects to highlight in this area. First, communication is important to surviving the long and often bumpy ride. Long-term investors not only need to get the investment call right but also need to maintain stakeholder confidence that the investment strategy will most likely turn out right, even if current market prices indicate otherwise. At GIC, we try to make sure that the next-highest level in our organization understands the risks and challenges involved before embarking on an activity.

Second, we are conscious that nomenclature is destiny. The right word engenders the right attitude and the right behavior. From how a report is presented to how an investment loss is explained and how a concept is described, we are meticulous about word choice, as well as how we deliver the message. For example, we avoid displaying only short-term performance results, especially at important forums. This is to prevent the perception that we emphasize short-term results. We avoid using a phrase such as "consistent results" so that our teams do not wrongly focus on quick bets and quarterly gains. We prefer to say "sustainable results." We find that a nice saying such as "the long-term is but a series of short-terms" is extremely harmful. In our view, it is not true—at least not for investing. We would correct someone in our organization if he or she used that phrase or one like it. The drivers of short-term investment outcomes and the drivers of long-term investment outcomes are very different. In most cases, the former have to do with market emotions, while the latter have to do with fundamental developments such as competitiveness. Think of Benjamin Graham's "voting" and "weighing" machines. The wrong words can corrode, if not corrupt, our process.

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Long-termism and a value orientation are at the heart of all we do, but to put these principles into practice requires constant vigilance and discipline. The entire ecosystem must share the same orientation, especially in the areas of investment philosophy, governance framework, investment mandate, organizational practices, and communication. If we get those things right, however, we believe we will be rewarded with achieving the investment goals we have set for ourselves. ■