FEATURE ARTICLE NO: 1

LONG-TERM INVESTING

The Government of Singapore has entrusted GIC with managing its funds for the long term. This allows GIC to adopt a long-term investment approach – maximizing long-term returns while managing short-term market fluctuations.

Our long-term investing approach allows us to adopt two strategies that other investors may not be able to: harvesting returns from riskier assets and taking contrarian stances when markets are at extremes.

HARVESTING RETURNS

In the long term, riskier asset classes should deliver better returns in order to compensate investors for taking on more risk. By investing in risky assets, investors trade off uncertain payoffs for potentially higher returns over time. We call the extra return earned for investing in a risky asset the asset's risk premium. It takes patience to harvest risk premiums because the extra returns accumulate slowly and unpredictably over time, but GIC's long-term investment approach allows us to do so.

Possibly the most important risk premium in financial markets is the equity risk premium (ERP). The ERP is the additional return that stocks deliver over the risk-free rate earned from long-term treasury bonds. This extra return compensates investors for taking on the higher risk of the equity market. While investors may disagree over the exact definition of the ERP, most do not dispute that it exists. Historically, the global ERP has been around 4-5%.

Apart from the ERP, risk premiums have also been observed in other asset classes. Bonds, which represent long-term loans, offer a higher interest rate than short-term deposits to compensate for the risk that interest rates might change. Real estate and private equity, which are less liquid and more difficult to trade, also offer higher returns to compensate for the additional risks.

The Government's portfolio has a significant exposure to equities and equity-related asset classes as shown in Chart 1. These asset classes offer access to the attractive long-term ERP and other risk premiums. Our long-term investment horizon allows us to harvest these risk premiums while accepting short-term

CHART 1: ASSET CLASS COMPOSITION OF THE GOVERNMENT'S PORTFOLIO, MARCH 2012

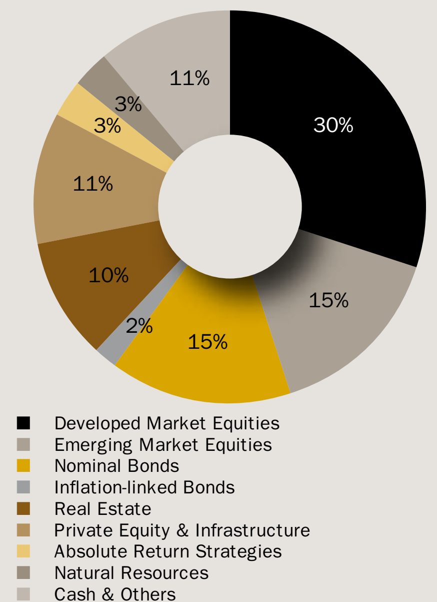
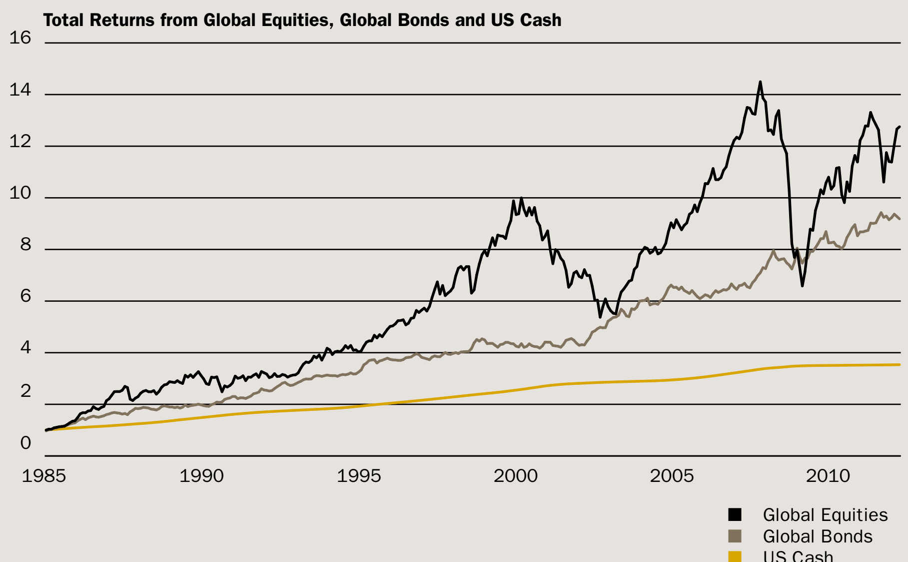
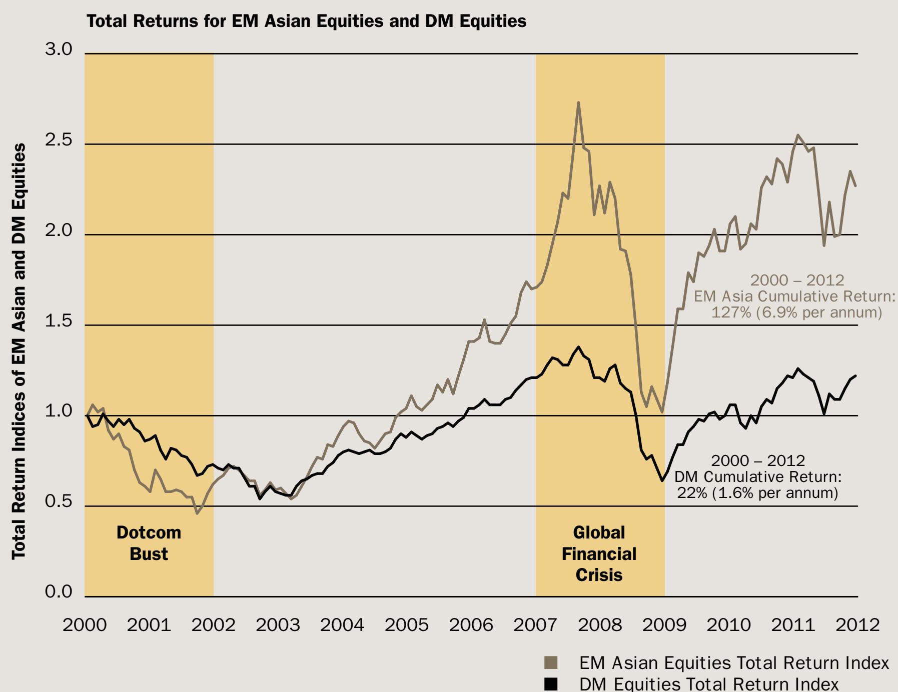


CHART 2: HARVESTING RETURNS FROM ASSET CLASSES [1]



[1] Global equities are represented by the MSCI World Total Return Index (USD) (1985 – 1988) and the MSCI All-Country World Total Return Index (USD) (1988 – 2011), and Global bonds are represented by the Citigroup WGBI All Maturities Total Return Index (USD).

CHART 3: EM ASIAN EQUITIES VERSUS DM EQUITIES [2]



[2] Developed Market (DM) equities are represented by the MSCI World Total Return Index (USD), and Emerging Market (EM) Asian equities are represented by the MSCI EM Asia Total Return Index (USD).

price fluctuations. Over time, these risk premiums compound into superior portfolio returns.

As shown in Chart 2, even though global equities fell substantially during the Dot-Com crisis (2000 – 2003) and Global Financial Crisis (2007 – 2009), staying the course and harvesting the ERP would have led to positive returns over cash and bonds. Since it is difficult for a large investor like GIC to time market falls and rises, GIC accepts some short-term setbacks to achieve our long-term investment goals.

Another example of a risk premium that GIC has harvested is the emerging market risk premium. Emerging market assets are more volatile than developed market assets in the short term. Emerging markets may also be riskier in other respects, such as presenting a higher probability of fraud, loan default and lower tradability during periods of market stress.

Despite the greater risks, GIC decided to increase our exposure to emerging market equities in 2003. This decision was based on two beliefs. First, the boom-and-bust cycles that plagued emerging markets in the past would be less severe in future because emerging markets governments and companies have strengthened their governance frameworks. Second, and more importantly, these structural improvements in emerging economies would be sustained. Hence, GIC took the view that emerging markets would outperform developed markets in the long term.

Since 2003, GIC has built up its exposure to emerging market equities to 15% of the portfolio, with a concentration in emerging Asia. Emerging market Asian equities have returned 127% since 2000, whereas developed market equities returned only 22% over the same period.

CONTRARIAN STANCE

A strategy of harvesting long-term risk premiums does not mean that investors should simply buy financial assets and wait. The prices of potential investments often do not reflect their true, fundamental value. For example, investors bid up technology stocks during the late 1990s, leading to the Dot-Com boom that eventually collapsed. On the flip side, recessions often drive many investments to bargain prices. These deviations from fundamental value are often caused by short-term market sentiment and herd behavior – irrational urges that an astute investor should not act on. Some of these deviations may also be amplified by investors' circumstances, for example, investors who use investment returns to fund regular payouts may have to sell assets during a crisis to raise cash because returns have become zero or negative.

As a long-term investor, GIC has the flexibility to take a contrarian stance, taking positions against the crowd when markets deviate significantly from fair value. Because GIC's performance is assessed over the long term, and the portfolio does not face regular large withdrawals, we can accept possible short-term underperformance against our expectations in return for longer-term gain.

GIC attempts to determine the intrinsic value of our investments. GIC buys assets when their prices are below intrinsic value and sells them when they are expensive. This is not easy because markets generally function well, but one such episode occurred during the Global Financial Crisis of 2008.

CONCLUSION

GIC's long-term investment horizon is a competitive advantage which should continue to be exploited to produce better returns for the Government's portfolio.

Long-term investing enables GIC to harvest risk premiums from different asset classes. It also allows us to take a contrarian stance when short-term deviations are extreme and prices are significantly away from their long-term fundamentals. But we can only enjoy the rewards of long-term investing if we are prepared to tolerate short-term losses or underperformance relative to market indices from time to time.