

Investment Beliefs

Every asset manager should have them.

Alfred Slager and Kees Koedijk

Asset managers should worry less about the stocks and products they pick for their clients and more about getting their investment beliefs right. After a steep decline in the global stock markets and a recovery that is still uncertain, surviving in the asset management industry is probably one of the toughest challenges around. All that counts in the end are the investment returns you achieve for your client, whether a private client or pension fund. In this cut-throat industry, it is simply not enough to have a good organization, a good staff, and a well-defined and embedded mission.

Investment beliefs improve stakeholder governance by reducing possible conflicts of interest, and charge the innovative adaptability of an organization by setting guidelines for best practice. Managers need to formulate their own investment beliefs: a clear view on how they perceive the way capital markets work, and how their organizations can add value and strive for excellence.

Our objective is to unearth these investment beliefs, and show how asset managers can use them to their advantage, expanding on Ambachtsheer [2004] and Raymond [2004]. We present the results of a survey that examines investment beliefs from the world's leading pension funds, asset managers, and endowment funds. Together the responses provide a broad-based and coherent view of today's state of the art views in asset management. Three groups of investment beliefs emerge: capital markets beliefs, organizational skill beliefs, and societal beliefs. We show how to use investment beliefs to one's advantage.

THEORY BEHIND INVESTMENT BELIEFS

Consumer firms have beliefs about how people make purchasing decisions. Similarly, investment firms have beliefs

ALFRED SLAGER

is an assistant professor of finance at RSM Erasmus University in Rotterdam, The Netherlands, and an advisor at PGGM Investments.
ASlager@rsm.nl

KEES KOEDIJK

is a professor of finance at RSM Erasmus University, and a fellow of CEPR.

about valuation and about how financial markets function (Ambachtsheer [2004]). Investors have to rely on beliefs because there is little that can be proven conclusively in the field of finance.

Financial theories do not have the same degree of confidence as theories in physical sciences for two reasons (Raymond [2004]). First, finance is a relatively young discipline. Modern finance is roughly 50 years old, and other disciplines have been shaped over several hundreds of years. All theories have not been road tested. Basic premises are not conclusive. For example, for more than 30 years economists have debated whether financial market prices are efficient or not.

Such a debate has far-reaching consequences. Those who believe markets are efficient advocate indexing and other passive strategies such as buy-and-hold, weathering the peaks and troughs of price cycles. Believers in inefficient markets usually invest in what they perceive as undervalued stocks, sectors, or assets, and do not shy away from market timing investment (Brav and Heaton [2003]). In addition, the seemingly new regime with lower investment returns and aging population will severely test the extrapolation power of theories.

Second, financial data are noisy. It takes a lot of effort to extract relevant information from price signals, and models have generally low predictive power for future returns. New mathematical techniques, the field of econometrics, have been developed to cope with this.

WHY FORMULATE INVESTMENT BELIEFS?

Formulating investment beliefs matters for two reasons. Investment beliefs improve stakeholder governance by reducing possible conflicts of interests, and improve the innovative adaptability of an organization by setting guidelines for best practice. Stakeholder governance is about aligning the interests of stakeholders within an organization, minimizing agency costs. Agency costs between plan sponsors and plan participants must be considered when explaining the investment choices made by defined-benefit pension plans (Lakonishok, Shleifer, and Vishny [1992]).

Jensen and Meckling [1976] were the first to characterize the modern organization as an agency relationship. Agency costs represent the loss in (shareholder) value when there are conflicts of interests between shareholders and managers and debtholders. Agency costs are the sum of monitoring costs, bonding costs, and residual loss.

Monitoring costs are expenditures paid by the principal (shareholders) to measure, observe, and control an agent's behavior. Examples are cost of audits, budget restrictions, compensation policies, and operating rules. For an investment firm, the formulation of investment beliefs is then an efficient tool to reduce monitoring costs.

Investment beliefs represent a shared understanding among investment professionals, management, and fiduciaries. Without them, it is likely that decisions made by an investment professional do not coincide with fulfilling the mission for an organization. Brown [1999], for example, reports lower returns on university endowments than expected, and suggests a link between the lower return and the possibility of divergent interests in a large portion of externally managed assets.

Clear investment beliefs with a properly defined investment policy restrict and focus capital market activities that an investment manager deploys to achieve long-term investment objectives. Investment beliefs form the framework for internal and external accountability. While external accountability is a structural trend, pension funds, as yet, do not have to publish their investment beliefs.

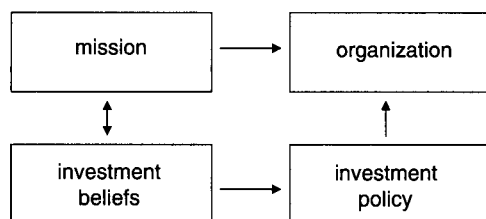
Besides improving alignment of interests, investment beliefs also improve the innovative adaptability of an organization and can be instrumental in preventing adverse herding behavior patterns within the organization. Financial innovations have developed at a dramatic rate over the last decades (Allen and Santomero [1998]). There are ample opportunities to fine-tune portfolio construction techniques, investment strategies, and risk management opportunities. At the same time, the decline in realized and expected asset returns since 2004 has sent institutional investors on a return-yielding chase. After the surge in commodities investments in 2000–2004, hedge funds in 2003–2005, or private equity and high-yield bonds, investment managers continue to search for new opportunities. Defining investment beliefs should guide managers on where and where not to look for additional returns.

EMBEDDING INVESTMENT BELIEFS

Investment beliefs are implicit in every investment decision or strategy, but it is not common for them to be made explicit. Investment beliefs are important as they form a critical input to the development of an investment policy, and are therefore an important governance issue. They ought to be made explicit, documented, shared,

EXHIBIT 1

Asset Management Framework



and understood by fiduciaries as well as investment professionals (Ambachtsheer [2004]). Investment beliefs should be well embedded within the organization's mission and the organizational framework.

Exhibit 1 conceptualizes the framework. The mission guides the organization in its long-term goals. It should be clearly interpretable and describe accountability. Accountability clarifies the legal foundation needed to align stakeholder interests and minimize the potential for agency conflicts. *Interpretable* means that a governance process should crystallize the organization's mission and identify the critical elements needed to achieve it.

The investment beliefs are a set of beliefs that are instrumental in achieving the organization's mission. Investment beliefs should be visible in the blueprint and implementation of the organization, and represent a guide for new developments within the organization. They should also give employees a good understanding of the added value of the organization. In a knowledge-intensive organization, investment beliefs must stand the tests of reason, informed debate, and occasional revision when new evidence comes to light (Ambachtsheer [2004]).

The investment policy should be considered separately from investment beliefs. The policy is a practical translation of the investment beliefs for the asset management organization, and provides guidelines on how to set up the investment process. In the United States, the United Kingdom, and Ireland, pension funds are required to publish their investment policies, describing how they invest, not why.

Ideally, the organizational structure is based on the mission, investment beliefs, and investment policy to achieve the long-term goals. It creates a uniform and common platform for employees for realizing these goals. The organization is built around investment processes that integrate stakeholder risk tolerances, investment beliefs using combinations of seasoned judgment, and state of the art financial engineering techniques.

INVESTMENT BELIEFS: A TOUR D'HORIZON

So what do investment beliefs look like? To establish that, we examined investment beliefs among the world's leading fund managers, pension plans, and endowment funds. Together they provide a broad-based and coherent view of today's state of the art views in asset management.

We selected 16 of the world's largest asset managers: 3 pension plans, 2 endowments, and 11 asset managers. The investment beliefs were collected by checking the websites of the 30 largest pension plans and the 30 largest asset managers for published investment beliefs, according to lists drawn from the Pensions and Investments 2004 Databook.

Forty-four organizations did not publish investment beliefs at the time of the survey, in July 2005. One asset management initiative was added: Enhanced Analytics Initiative, an institutional investor initiative to stimulate a broader research process.

The survey includes North American and European organizations, where the world's assets are concentrated. Six organizations are U.S.- and Canadian-based; the others are located in Europe. Together, they manage USD 3,658 billion of assets. The organizations are listed in Exhibit 2.

Ambachtsheer [2004] provides a basis for identifying different elements that can be addressed in an investment belief. We classified and expanded the elements for the survey. Next, we clustered these investment beliefs and searched for commonalities. Although the resulting sample is too small to support rigorous statistical analyses, it is diverse enough for us to identify common patterns and differences.

We consider three sets of beliefs: about capital markets, about organizational skills, and about society.

- Capital Markets
 - Theoretical sources of efficiencies and inefficiencies that can or cannot be exploited.
 - Investment process to exploit these inefficiencies.
 - Risk attitude; relation between risk and return.
 - Asset pricing and investment horizon.
- Organizational Skills
 - Operational costs.
 - Competencies of own organization.
- Society
 - Corporate governance.
 - Sustainable investments.

EXHIBIT 2

Managers with Published Investment Beliefs

Organization	Country	Type	Assets Under Management, (millions of US dollars)
UBS	Switzerland	Asset manager	1,782,000
Capital Group	United States	Asset manager	814,097
Vanguard	United States	Asset manager	725,300
Deutsche Asset Management	Germany	Asset Manager	714,889
Northern Trust	United States	Asset manager	478,626
ING Asset Management	Netherlands	Asset manager	350,000
TIAA-CREF	United States	Pension plan	350,000
T. Rowe Price	United States	Asset manager	189,960
Foreign & Colonial	United Kingdom	Asset manager	114,256
Pictet	Switzerland	Asset manager	98,000
Hermes	United Kingdom	Asset manager	78,228
Canadian Pension Plan	Canada	Pension plan	53,895
ATP	Denmark	Pension plan	44,382
University Superannuation Scheme	United Kingdom	Pension plan	36,607
AXA Rosenberg	United States	Asset manager	33,000
AP Fonden	Sweden	Pension plan	13,473
Local Authorities Pension Plan	Canada	Pension plan	7,448
Edmonton Tel Endowment Fund	Canada	Endowment fund	1,850
Enhanced Analytics Initiative	United Kingdom	Institutional investors initiative	-

At first glance, all eight investment beliefs seem plausible. In fact, we show that in a model in which fund managers compete with each other to add value, clear choices have to be made.

Efficiencies and Inefficiencies

A classic tenet in the investment literature is the efficiency of markets. Investment beliefs should start with a view on efficiency. Is the pricing of securities or assets perfectly efficient, or less than perfectly efficient? If the pricing is less than perfectly efficient, what then is the inefficiency? Since the 1970s, investment professionals have adhered to either the strong variant of the efficient markets hypothesis or the semi-strong (or even weak) efficient markets hypothesis.

Financial markets are not a homogeneous pool of capital. In the United States, large corporations listed on the New York Stock Exchange are traded in large volumes and covered by numerous stock analysts, creating very efficient markets where investment returns are only partially predictable.

AXA Rosenberg believes "markets are reasonably efficient but not perfectly efficient. . . it is difficult to add

value consistently by betting on countries or sectors or by timing the markets." Vanguard finds that "consistently outperforming the financial markets is extremely difficult." Pictet maintains a bottom-up approach, believing that "the price of a financial asset should reflect the present value of its future cash flows." UBS finds that "intrinsic value is determined by the fundamentals that drive a security's cash flow."

Investment Process to Exploit Inefficiencies

An investment process combines all the necessary steps to move from conceptualization (the investor's mission) to realization (achieving returns related to risk attitude and established goals). Ideally, the investment process should be designed to exploit the inefficiencies. If assets are efficiently priced, portfolio construction and overall risk management should be a major part of the process. If individual securities are inefficiently priced, some bottom-up process is needed to select and exploit these individual mispricings.

Investment firms take several approaches. An important theme is mean reversion to reflect asset mispricing. For the City of Edmonton, "Capital markets are mean reverting over long periods of time. . . Periods of stellar performance will be followed by periods of more moderate performance and vice versa."

UBS believes that "discrepancies between market price and intrinsic value arise from market behavior and market structure, providing opportunities to outperform." AXA Rosenberg believes that "mispriced stocks can be identified by rigorous analysis of fundamental data." The Local Authorities Pension Plan (LAPP) concentrates on the setting of the asset mix policy, "the most important investment decision . . . explaining about 90% of the variability of investment returns."

Deutsche Asset Management finds new investment opportunities on the assumption that:

current market valuations reflect the balance of expectations, the consensus view . . . rather than all the information that is actually available. We use our comprehensive proprietary research facilities to look for the most important factors influencing market prices, and identify inefficiencies in the capital markets.

Risk Attitude and Risk-Return Relation

Investors are generally risk-averse and require expected risk premiums before holding investments they deem risky. Investment risk is contextual, so the riskiness of any investment depends in part on the objectives of the investor. The relation between risk and risk premium is not linear. Also, the relation for the investor is not linear.

In low-return environments, institutional investors and regulators move increasingly toward an S-shaped interpretation of risk. Avoiding downside risk becomes more beneficial because of the increasing penalties attached to it, such as covering a shortfall.

A starting proposition for LAPP is that "taking risk to improve long-term investment return is both necessary and appropriate." LAPP also provides a definition of risk: "the possibility that contribution rates will have to be increased." Vanguard Investments believes risk has two dimensions for its clients; the investor should "weigh shortfall risk . . . against market risk, or the chance that returns will fluctuate." Few investment firms note that "broad diversification, with exposure to all parts of the stock and bond markets, reduces risk."

Asset Pricing and Investment Horizon

Predictive processes have either long-horizon or short-horizon orientations. Statistically, the longer the investment period, the lower the standard error of the estimated return becomes.

Long-horizon processes focus on projecting and valuing uncertain future cash flows and are positive-sum games. Such cash flows can theoretically sell at relatively high prices (and offer relatively low prospective returns) in optimistic investment regimes and at relatively low prices (and offer relatively high prospective returns) in pessimistic investment regimes. Short-horizon processes focus on predicting and exploiting temporary securities pricing discrepancies.

Pictet assumes that "value measures give no indication about the short-term return of a financial asset, but valuation is central to the long-term (five years and over) return estimate." Also, "in the short run, the economy can be better predicted on the basis of the financial markets than the other way around."

Operational Costs

All else equal, lower investment costs are always better than higher investment costs. Reducing costs can be an investment belief based on economies of scale. Avoiding high-cost assets (such as private equity or hedge funds) or focusing on low-cost strategies in large, liquid, efficient markets could be the other investment belief.

Only Vanguard believes that "minimizing the costs of investing is vital for long-term investment success." LAPP also focuses on costs, believing that "adopting different investment styles can reduce the potentially positive impact of active management, can increase the cost of managing the pension fund and can increase the time and cost of monitoring the investment management."

Competencies of an Organization

An investment organization has several strategic choices about how to set up and implement its investment goals. These choices should be linked to exploiting the competencies of the organization. One important question, for example, is whether assets should be managed internally versus externally. A related organizational skill is therefore the selection and monitoring of external mandates.

ATP assesses:

whether in-house asset management will allow us to realize our vision or whether external management offers greater advantages. . . . We manage assets in house only if we are convinced that we have the expertise to achieve attractive risk-adjusted returns and have sufficient resources to focus on the assets.

The board of LAPP believes that:

the different investment styles that may be used to actively manage an asset class can perform differently at different times and that by combining two or more investment styles, through multiple investment managers or multiple products, the volatility of the rate of return of that asset class can be reduced.

Corporate Governance

Some of the most spectacular corporate collapses and losses in recent memory have highlighted the role of corporate governance practices in maintaining viable entities,

and safeguarding investors' interests. A number of studies show a strong link between good corporate governance and strong profitability and investment performance measures. Research carried out by the California Public Employees Retirement System (CalPERS) on the effects of the system's Focus List suggests that efforts by investment funds to improve the governance of companies that are considered poorly governed also produces good returns in excess of market performance. For corporate governance structures to work effectively, shareowners must be active and prudent in the use of their rights.

Shareowners must act like owners and continue to exercise the rights available to them. PGGM believes that "active exercise of shareholder rights by investors can generate higher investment results. . . . Good corporate governance helps to raise the share price." This is implemented by defining and applying voting guidelines, as well as disclosing voting behavior.

The approach at Hermes is based on the belief that "companies with concerned and involved shareholders are more likely to achieve superior long-term returns than those without." Active shareowner involvement could help consistently underperforming companies as a result of structural or strategic governance weaknesses.

Sustainable Investments

Few investment firms hold outspoken views on sustainable investments, and if they do, these views are not generally published alongside a firm's investment beliefs. Both the merits and the most efficient application of sustainable investments to portfolio management are hotly debated. The minimalist approach is to view sustainable investing as another investment style; environment, society, and governance are integrated as one of the factors in mainstream alpha-driven strategies.

It represents a true investment belief when an organization links sustainable investments with a long-term view of capital markets and society. Supporters of sustainable investments believe there is either a "capital gap" to be filled or a "sacrifice" required (Ghilarducci [1994]).

Capital gaps are caused by market failures such as information asymmetries; investors do not take into account all relevant information, or do not price information correctly, creating mismatched combinations of risk and return for different stocks or sectors; proponents of an efficient market argue on the other hand that at any time the market price reflects the fundamental value of the firm.

Sustainable investors believe that companies with adequate sustainable policies deliver on average superior earnings and will be rewarded with above-average investment returns.

The second approach to sustainable investments is sacrifice, which means giving up risk or return objectives to achieve a non-financial goal. Restrictions and constraints on the investment universe to incorporate sustainable goals will create suboptimal risk-return combinations compared to the best portfolios that are managed with no other consideration other than risk-adjusted return. Yet sustainable investments seem to provide at least comparable risk return characteristics as normal investments (see Derwall et al. [2005]).

The National Association of Pension Funds urges British trustees to promote corporate social responsibility with the companies they hold shares in; sustainable investments are considered an integral part of the investment process. Other approaches are shareholder activity and reporting, such as the Principles for Responsible Investment (PRI), embraced by the United Nations and signed by more than 50 financial firms. The PRI requires signatories to integrate sustainable investments into the mainstream investment process as part of fiduciary duty.

NO INVESTMENT BELIEFS? TRY REENGINEERING

The scarcity of published investment beliefs suggests that many asset managers have yet to explicitly formulate their investment beliefs; fewer than 20% of firms publicize their beliefs. A practical approach would be to examine the implicit strategies represented in current conditions (Mintzberg and Quinn [1995]). Using the investment policy and other strategic documents, the organization can uncover its investment beliefs and use them as a framework for evaluating the desired configuration of mission, investment beliefs, investment policy, and organization.

With these results in mind, has the current asset management organization the resources and competencies to realize its investment policy to implement these investment beliefs? Where are the gaps, and which competencies should be bolstered?

A typical pension plan might have two goals: Execute the strategic asset allocation to achieve at least the benchmark return, and realize outperformance of the benchmark return. We assume that the managed assets are broadly diversified, and part of the assets is managed internally. We now have to work our way backward to retrieve the hidden investment beliefs.

For example, executing the strategic asset allocation assumes that markets are highly efficient. Inefficiencies cannot be exploited in the long term. Emphasis on risk diversification, passive strategies, and low costs should therefore be expected.

Realizing outperformance beyond the benchmark return suggests, however, that the organization has a clear view on which inefficiencies or skills it can exploit, mean reversion or inefficient asset pricing strategies, or the skills to select the right external manager who can do so. This competence should be made explicit by trustees.

Any active asset manager or pension fund has a set of investment beliefs, even if they are not in writing. They should be made explicit, and then checked to see which investment beliefs truly apply to the asset management organization. Writing down investment beliefs requires one to have a view on capital markets. Somewhere between four and six investment beliefs should suffice, depending on the complexity of the organization. These investment beliefs then form a sound basis for formulation of the investment policy.

If you don't have a view, say so. Once the beliefs are written down, you might check them on effectiveness, validity, and coherency.

- Do the investment beliefs form a coherent set of beliefs? Do the investment beliefs reinforce (e.g., efficiency of markets and cost base) or contradict each other? Do combined investment beliefs give you something upon which to base your investment policy? Can the investment beliefs be identified separately in the investment process?
- Can one design an investment policy based on these investment beliefs? The translation of investment beliefs into investment policy should be straightforward; otherwise, the investment beliefs need to be reformulated.
- LAPP takes a practical approach in creating a table where each investment belief is followed by its translation into investment policy. One investment belief is that "taking risk to improve long-term investment return is both necessary and appropriate. . . . Setting asset mix policy is the most important investment decision." To apply this investment belief, the board will "have a bias towards equities, based on an assessment of risk, to add long-term value . . . and determine strategic long-term asset mix."
- Do investment beliefs justify the structure of your organization? If the investment management

organization has identified long-term mean reversion as the main inefficiency on which to base a strategy, and the current strategies tend to be short-term-focused, there clearly is a misalignment. Formulating investment beliefs is the first step in identifying the misalignment, and correcting it.

- Can investment managers relate to the investment beliefs and communicate them? Accountability to trustees, clients, and participants is growing in importance. The investment beliefs should provide the investment manager with a framework to explain the choices made, or the choices to be made, enhancing the organization's own governance. Also, they should provide clients and trustees with the proper attribution framework to judge the results.

CONCLUDING REMARKS

We have argued, like Ambachtsheer [2004] and Raymond [2004], that a coherent set of investment beliefs provides the basis for a good investment policy. Investment beliefs imply a clear view on the capital markets (the inefficiencies to exploit, the risk-return relation, the relation between asset pricing and investment horizon), recognizing the competencies of an organization (cost-effectiveness, organization-specific values), and developing a view on societal issues that affect investments (sustainable investments, corporate governance). More research is needed about long-term gains. Do organizations with well thought-out investment beliefs achieve better returns than organizations that do not? Ambachtsheer suggests as much; this needs broader validation, however, and provides a future research agenda.

REFERENCES

- Allen, F., and A. M. Santomero. "The Theory of Financial Intermediation." *Journal of Banking and Finance*, 21 (1) (1998), pp. 1461-1485.
- Ambachtsheer, K. "Should (Could) You Manage Your Fund Like Harvard or Ontario Teachers?" *The Ambachtsheer Letter*, 219, April 2004.
- Brav, A., and J. Heaton. "The Real Questions About Market Efficiency." *Financial Times*, August 27, 2003.
- Brown, W. O. J. "University Endowments: Investment Strategies and Performance." *Financial Practice and Education*, Fall/Winter 1999.

Derwall, J., N. Guenster, R. Bauer, and K. Koedijk. "The Eco-Efficiency Premium Puzzle." *Financial Analysts Journal*, March/April 2005, pp. 51-64.

Jensen, M., and W. Meckling. "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure." *Journal of Financial Economics*, (1976), pp. 305-360.

Lakonishok, J., A. Shleifer, and R. Vishny. "The Structure and Performance of the Money Management Industry." *Brookings Papers*, 1992, pp. 339-379.

Mintzberg, H., and J. Quinn. *The Strategy Process*. Hemel Hempstead: Prentice-Hall International (UK) Limited, 1995.

Raymond, D. "Investment Beliefs." Presented at the Centre for Pension Management Colloquium, Rotman School of Management, University of Toronto, October 5-6, 2004.

To order reprints of this article, please contact Dewey Palmieri at dpalmieri@ijournals.com or 212-224-3675.

©Euromoney Institutional Investor PLC. This material must be used for the customer's internal business use only and a maximum of ten (10) hard copy print-outs may be made. No further copying or transmission of this material is allowed without the express permission of Euromoney Institutional Investor PLC. Copyright of *Journal of Portfolio Management* is the property of Euromoney Publications PLC and its content may not be copied or emailed to multiple sites or posted to a listserv without the copyright holder's express written permission. However, users may print, download, or email articles for individual use.

The most recent two editions of this title are only ever available at <http://www.euromoneyplc.com>