# The search for a long-term premium

**By Liang Yin**

Jaap van Dam, principal director of investment strategy at PGGM, one of the world's largest asset owners known for its commitment to long-horizon investing, once asked what he called the million-dollar question: "Can we be reasonably certain that we will be rewarded for being a long-horizon investor? Because, if we're not, then why bother?"

We have been grappling with this issue within the Thinking Ahead Institute for some time now, and at the start of 2017 formed a working group of members who shared our passion to make more definitive progress on the matter. The first fruit to emerge from this initiative is a paper called "The search for a long-term premium,"[1] with more recent papers focused on helping investors access this premium.

Its conclusion is that a sizable net long-term premium indeed exists.

## The search

Quantification of the long-term premium is easier said than done. In an ideal world, we would have run a regression of net investment returns against investors' time horizons. But the data simply doesn't exist.

We therefore used an indirect approach, based on identifying return opportunities and ways to reduce the drag on returns that are only compatible with a long-horizon investing approach. This resulted in eight building blocks, each practical to implement, albeit with changes required to an investment process. Together, these provide evidence of a sizable premium available to genuine long-horizon investors; we discuss these building blocks later, split into opportunities to exploit and potential drags on return to avoid.

[1] www.thinkingaheadinstitute.org/en/Library/Research-and-Ideas/The-search-for-a-long-term-premium

*Capturing the benefits of long-horizon investing will require a major shift of mindset and significantly expanded skillsets by investors.*

## Long-horizon return opportunities

**1. Active ownership**

It has been shown[2] that engagements with investee companies generated, on average, excess returns of 2.3% in the year following the initial engagement. We believe this provides clear evidence of the benefits of being active owners encouraging investee companies to take long-term approaches.

**2. Liquidity provision**

When investors are willing to pay for liquidity – in other words, sell assets below "fair value" – the other side of the trade gets paid. One study[3] suggested that long-horizon investors have the potential to earn additional returns of 1.0% pa by providing liquidity when it is most needed.

**3. Illiquidity risk premium**

When investors accept illiquidity, they accept greater uncertainty about the outcome because they are less able to liquidate the asset. The longer the capital is tied up, the more return investors expect by way of compensation. Some academic studies[4] pointed to a range of 0.5% to 2% pa for this particular premium.

**4. Capturing systematic mispricing**

The fourth return opportunity for long-horizon investors comes from exploiting various mispricing effects via factors or smart betas. Decades of data[5] suggested that this can add more than 1.5% pa relative to the cap-weighted index.

**5. Thematic investing**

Investors have long been aware of thematic investing, and belief in its ability to create value appears to be strong. However, we feel the lack of consistency in implementation approach means we have been unable to find empirical evidence that categorically demonstrates the possibility of success of a thematic approach.

## Avoid drags

**6. Avoid buying high and selling low**

A long-horizon mindset can usefully guide behaviors to avoid chasing past performance. A study[6] estimated that by replacing their investment managers, a group of U.S. plan sponsors gave up, on average, a cumulative 1.0% in the three years following the change.

**7. Avoid forced sales**

We feel open-ended fund structures, despite the flexibility they provide, might not be fit-for-purpose for long-horizon investors. In such a structure, long-horizon shareholders effectively subsidize their short-horizon peers for their liquidity needs. It has been found[7] that liquidity-driven trading in response to flows (in particular, redemptions) reduced returns in U.S. open-ended mutual funds by 1.5% to 2.0% pa.

**8. Potentiality lower transaction costs**

The last but not least building block, is the possibility of significant savings in transaction costs, which can be made by avoiding unnecessary turnover as a long-horizon investor.

## It's all about governance

We believe capturing the benefit potential of long-horizon investing will require a major shift of mindset and significantly expanded skillsets by investors. We take two hypothetical funds to develop a reasonable estimate of the potential net long-term premium in practice:

- The smaller fund (c. $1 billion) focuses on avoiding the drags. It seeks to reduce manager turnover, avoids chasing performance and moves part of its passive exposure into factor strategies. The rationale is: If you don't have the resources to win big, at least don't lose.
- The larger fund (c. $100 billion) has the governance and financial resources to consider all available options. It introduces long-horizon return-seeking strategies while seeking to reduce any drags.

In the investment world where there are very few universal truths, it would be a little arrogant to conclude that we have proven the existence of the long-term premium. We are, however, "reasonably certain" that any costs of developing the mindset and acquiring the skillsets to address long-horizon investing challenges are substantially outweighed by the potential return enhancements.

[2]"Active Ownership," Dimson et al, *Review of Financial Studies*, 2015, Vol. 28, Issue 12

[3]"Long-term investing: An institutional investor perspective," Geoff Warren, 2014, CIFR

[4]"Long-term investing: An institutional investor perspective," Geoff Warren, 2014, CIFR

[5]"The Surprising Alpha from Malkiel's Monkey & Upside Down Strategies," Arnott et al, *The Journal of Portfolio Management*, 2013, Vol. 39, No. 4

[6]"The Selection and Termination of Investment Management Firms by Plan Sponsors," Goyal and Wahal, *Journal of Finance*, 2008, Vol. 63, No. 4

[7]"Investor flows and the assessed performance of open-end mutual funds," Edelen, *Journal of Financial Economics*, 1999, 53(3)