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Te Kaitiaki Tāhua Penihana Kaumatua ō Aotearoa

TITLE:

Investment Beliefs

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Introduction

What are beliefs?

- There are few absolute investment truths.
- There are no universally-agreed or universally-appropriate methods on many questions concerning the financial markets.
- For example, the evidence on the following questions is mixed or undecidable
  - Does alpha (skill) exist? Is it fleeting or persistent, rare or common?
  - How much diversification is ‘enough’ in markets that are unquantifiably imperfect?
- Investment beliefs are a consistent way of thinking about financial markets *in the specific context of a given investor*. They cannot be definitively proven and are instead collectively agreed and collectively held judgments based on literature, research and experience.
- Therefore, beliefs
  - provide clarity of thought
  - bind many individual perspectives into a disciplined institutional whole
  - allow for the diverse investment universe to be evaluated consistently
  - provide the succour and courage to stay the course when most needed.

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Developing our Investment Beliefs

The Guardians of New Zealand Superannuation have adopted a three-step process to developing our Investment Beliefs:

1. Understand the fundamentals of risk and return
   - How to measure expected risk and its relationship to expected returns
   - Asset valuation
   - Implementation costs

2. Have a sound framework for how markets work. An investment belief is generally formulated by observing the financial marketplace. For example, we observe that market prices over react to news. This often includes a judgment component as to some human behaviour or fallibility, e.g., myopia or fads.
   - Understanding how a competitive market operates
   - Familiarity with research into investment strategies

3. Ensuring the investment beliefs are aligned with our **endowments**:
   - Sovereign status – our sovereign status helps improves Fund returns by reducing foreign tax leakages; this status positions the Fund well as a potential co-investor of choice.
   - Independent investment responsibility – our investments are made on a purely commercial basis.
   - Certain liquidity profile – the flow of cash into and out of the Fund is governed by a funding formula, which is public. This provides us with certainty and transparency on cash flow timing.
   - Long Fund horizon – the longevity of the Fund allows us additional flexibility to undertake investments with longer-term return characteristics and to be relatively more tolerant of market volatility.

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Our Beliefs

	Beliefs	Facts
Governance and Objectives	Clear governance and decision-making structures that promote decisiveness, efficiency and accountability are effective and add value to the Fund.	It is important to be clear about investment objectives for the Fund, risk tolerance, and the timeframe over which results are measured.
Asset allocation	Asset allocation is the key investment decision. Investors with a long-term horizon can outperform more short-term focused investors over the long-run.	Risk and return are strongly related. There are varied investment risks that carry premiums/compensations. Illiquidity risk is one such premium. Investment diversification improves the risk to return (Sharpe) ratio of the Fund.

Our Beliefs

	Beliefs	Facts
Asset class strategy and portfolio structure	Asset class expected returns are partly predictable and returns can revert toward a mean over time	Investment markets are competitive and dynamic, with excess returns very difficult to find and constantly changing source. Market volatility tends to cluster over short horizons but mean-reverts over longer horizons. Investment risks can be unbundled to make the Fund more efficient. This includes the separation of market (beta) and investment specific investment manager skills (active returns).

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Our Beliefs

	Beliefs	Facts
Manager and Investment Selection	True skill in generating excess returns versus a manager's benchmark (i.e. pure alpha) is very rare. This makes it hard to identify and capture consistently.	The more efficient a market is, the more difficult it is for a manager to generate an excess return (versus their benchmark). Research signals and methods used by managers tend to commoditise over time through market forces. In some cases, synthetic exposure to a market or factor can provide a guaranteed additional return to the Fund.
	Some markets or strategies have characteristics that are conducive to a manager's ability to generate excess return.	
	These characteristics tend to evolve slowly over time, although the shorter-term opportunity set that may be available in any market/strategy can vary through the cycle.	
	Most active return is driven by a combination of the research signals the manager is using, the conduciveness of their market to generating returns, beta factors, and luck.	
	Responsible investors must have concern for environmental, social and governance factors because they are material to long-term returns.	

Our Beliefs

	Beliefs	Facts
Execution		Managing fees and ensuring efficient implementation can prevent unnecessary costs.

Case Study: Strategic Tilting

Using beliefs to motivate an investment strategy

- *Strategic Tilting* is one of the three main ways by which the NZSF adds value to a reference portfolio, the Fund's definition of a low cost easily accessible benchmark.
- Under the tilting program, broad listed asset class holdings are adjusted around their benchmark weights according to their expected relative returns.
- That is, it involves dynamically adjusting the long run risk profile embodied in the NZSF's reference portfolio.
- The tilting program is fundamentally predicated on two investment beliefs:
  - Asset classes returns are partly predictable and returns can revert to toward a mean over time.
  - Investors with a long-term horizon can outperform more short-term focused investors over the long run.

Strategic tilting is a 'contrarian' strategy that may imply an extended period of losses relative to long-run benchmarks. Being underweight an asset class in a bull market or overweight in a bear market can bring enormous pressure to unwind the strategy. Perhaps the worst possible outcome for a fund would be to abandon a position when valuations for an asset class prove to be extreme after the fact. For this reason, it is imperative that the Fund's Board is committed to the strategy – both from the perspective of buying into the investment beliefs behind the strategy, and being willing to defend the strategy in periods when it underperforms. Having consistent Investment beliefs bolsters the collective courage to stay the course.