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INVESTMENT GROUP

Investment Beliefs

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Investment beliefs are an area of investment fund governance that is of importance to many institutions. While not required by the Department of Labor or ERISA guidelines, Meketa Investment Group believes that having a statement of investment beliefs is a best practice to follow for institutional investors.

This paper explores the rationale for adopting a Statement of Investment Beliefs and guides decision-makers through the development process. It offers a list of questions that governing groups should ask in the development of investment beliefs, and it provides insight into the types of investment beliefs that institutional investors most commonly hold.

What are investment beliefs

Investment beliefs express the convictions that an institution's governing group has about financial markets, how their fund operates within those markets, and how their investment decision-making can potentially add value. Industry experts and academics have provided a number of definitions of investment beliefs.

- Investment beliefs "articulate the fundamental perceptions of stakeholders and their institutions on the nature of financial markets and the role they play within these markets."[1]
- Investment beliefs offer "a clear view on how [institutional investors] perceive the way capital markets function, and how their organization can add value with these views to their [beneficiaries]."[2]
- Investment beliefs are "conjectures and working assumptions about the investment world, including the economy, the financial system, social environment, and other risks that inform the underlying investment decision-making."[3]

Are Investment Beliefs Statements of fact or of values?

Investment Beliefs Statements can express values, but beliefs statements in general are not written to make a values-based decision. To the contrary, beliefs are intended to be objective statements of fact, and should be supported by well-understood theory and empirical evidence. While they may imply how the institutional investor should act, the beliefs are based on an established common understanding or set of experiences, not on unsupported judgment.

[1] Lydenberg, S. (2011) Investment Beliefs Statements, Initiative for Responsible Investment at Harvard University, IRI Working Paper.

[2] Slager, A., & Koedijk, K. (2007). Investment beliefs: The Importance of Focus for an Institutional Investor. Journal of Portfolio Management, 33(3), 77.

[3] Pensions & Investments (2012). Investment Beliefs Survey Results (joint study with Oxford University).

For example, if decision-makers believe markets tend to be mean-reverting by nature, there is no implied right or wrong, there is simply a question of whether it is true or false. Likewise, if a governing group does not believe that past performance is a strong indicator of future performance, this could change the way it selects asset managers.

Why are investment beliefs important?

Investment beliefs inform decisions and clarify roles and responsibilities. They influence everything, by:

- → Dictating the look and feel of the portfolio;
- → Providing clarity in assessing the investment policy options available;
- → Answering questions about trade-offs in resource allocation;
- → Being the lens through which portfolio performance is evaluated; and
- → Preparing the decision-makers against potential future criticism.

Stated investment beliefs make implicit assumptions explicit and provide a core understanding for the context in which an institution operates. This context helps determine the fund's investment priorities and policy. Additionally, because members of governing groups have finite terms, investment beliefs help provide investment guidance well beyond the tenure of any particular decision-maker and are more aligned with the long-term nature of most institutional investment pools.

By clearly stating the institution's tacit financial market assumptions, investment beliefs can help better define the Investment Policy Statement and all that builds upon that base.

Investment policies help formulate investment strategy, which in turn, leads to financial outcomes. Most governing groups have historically started with the development of an Investment Policy Statement. However, by clearly stating the institution's tacit financial market assumptions, investment beliefs can help better define the Investment Policy Statement and all that builds upon that base.

Why do institutional investors adopt investment beliefs?

Whether implicit or explicit, beliefs are the foundation upon which investors make decisions and which guide every choice. Importantly, explicit beliefs help ensure that investment decisions are made according to a framework of operating principles that is clearly understood by a governing group. They provide background about why investors made previous decisions and help ensure consistency in future decisions as membership turns over.

Steve Lydenberg, Fellow at the Initiative for Responsible Investment ("IRI") at Harvard University, has made two arguments for having explicit investment beliefs. First, doing so "help[s] assure that the decisions you make are consistent;" and second, "When things go wrong they can help you analyze the situation and decide if they went wrong because your beliefs were wrong or because the way you went about implementing them was flawed, and the beliefs themselves were fine."

Paul Matson, CEO of the Arizona State Retirement System ("ASRS"), cited four reasons why ASRS adopted investment beliefs a decade ago:

1. **Enhanced oversight** They enable the overseeing body to better understand why the portfolio is structured the way it is.
2. **Analytical consistency** They require investment staff to be consistent in how investment ideas, strategies, and products are analyzed and vetted.
3. **Decision-making consistency** They lead to enhanced consistency and clarity on how to make final investment decisions.
4. **Enhanced understanding** They ensure that better understanding by stakeholders, including pre-onboarding of potentially new employees and/or trustees, who should understand the investment paradigm that will largely determine research efforts and decision outcomes.[4]

[4] Via email conversation with Paul Matson, May 2016.

Does having investment beliefs lead to better outcomes?

Evidence shows there may be a relationship between having an Investment Beliefs Statement and higher future fund performance.

In their academic paper Investment Beliefs: The Importance of Focus for an Institutional Investor, Koedijk and Slager conducted an analysis to determine the relationship between beliefs and performance. Their results yielded two notable outcomes: "Holding strong investment beliefs about risk diversification is related to an improvement in the return/risk ratio for the organization," whereas conversely, "costs as a belief are not a differentiating element," and beliefs about fees did not show a correlation to better performance outcomes. Koedijk and Slager concluded that, "without investment beliefs, stakeholders and investment managers are bound to assess new investment strategies and make changes on an ad hoc basis, running the danger of creating sub-optimal results."[5]

[5] Slager, A., & Koedijk, K. (2007).

While this example is anecdotal, with time and a broader sample size, a more robust analysis of funds with investment beliefs should become possible.

Why have investment beliefs lately become a topic?

There are several reasons why investment beliefs are now being added to the list of controlling policy documents for institutional investors.

1. **Responsible fund governance.** Stated policies are a hallmark of good governance, and since investment beliefs guide investment decision making and all other policy documents that follow, it is logical that the development of a Statement of Investment Beliefs would be a best practice for stakeholders of a pension plan to adopt.

2. **Peers are adopting beliefs.** Institutional asset owners, especially in the public pension plan space, have been codifying Investment Beliefs Statements in recent years. In a notable instance, the California Public Employees' Retirement System ("CalPERS") approved and published eleven Investment Beliefs in September 2013. When changes occur within the public pension fund world, they can become industry standard best practices quickly. Many other public pensions, in greater numbers outside of the United States, have developed Investment Beliefs Statements as well, often incorporated directly into the plan's Investment Policy Statement and less frequently a standalone document. Some sophisticated institutional investors are now on their second or third generation of stated investment beliefs.

3. **Emerging best practices.** More information is becoming readily available about how to develop investment beliefs. In 2011, Koedijk and Slager published a comprehensive book that describes in detail how stakeholders can embark on an Investment Beliefs development project. While informative, the academic tone may make it less useful or tedious to use for decision-makers. More recently, the United Nations Principles for Responsible Investment ("UNPRI") developed a tool for asset owners to develop responsible investment policies that can be easily adapted to develop traditional investment beliefs.

4. **Better decision making.** An explicit set of investment beliefs help align the perspectives of a diverse governing group. A limited set of shared core principles can better position institutional investors to make difficult decisions.

How can governing groups best develop investment beliefs?

There is no exact route to take in formulating investment beliefs. Decision-makers may be more engaged or less engaged in the process; the beliefs may be more detailed or less detailed; and the process may be guided using in-house expertise or facilitated by an outside party.

> An outside perspective can facilitate decision makers in their discovery and articulation of what they do believe.

While guidance exists outlining the best practices to follow when creating Investment Belief Statements, the majority of the existing instruction comes from the responsible investing perspective. Harvard's IRI provides instructional tools that can be useful in undertaking an Investment Beliefs development project. Koedijk and Slager provide perhaps the most comprehensive outline for developing traditional beliefs statements, but all sources share similar guidance and highlight these general suggestions to follow:

→ Begin with a discussion about the purpose of a Statement of Investment Beliefs, and with the governing group reaching consensus on the desirability of doing so.

→ Develop beliefs statements in alignment with the mission, vision, and purpose of the institution.

→ Air decision-makers' views about investments and financial markets through interviews, surveys, and questionnaires with the aim of compiling an initial draft of beliefs.

→ Have vigorous debate within the governing group. These debates are a healthy part of the learning process that emerges through the development of these statements.

→ When adopted, the resulting beliefs statements should be clearly communicated to the governing group so that its members understand the basis for investment decision-making. Additionally, communicate them to new members when they join the institution (e.g., to newly-appointed trustees).

- Regularly revisit the resulting beliefs statements – for example, every three to five years, possibly in conjunction with reviews of Investment Policy Statements. Even if little changes, the act of reviewing the beliefs helps to remind decision-makers of them, and can help to focus the governing group when future decisions are before them. According to Gordon L. Clark, professor at Oxford University:

> *"Not only do (institutions) need to articulate beliefs and interrogate beliefs, they should also return to those beliefs for their coherence and the ways in which experience might undercut or reinforce those beliefs. There must be a process to revise beliefs. Otherwise, (investors) face the danger of locking into a suicide mission."*

Should investment beliefs be part of an Investment Policy Statement?

Placing a Statement of Investment Beliefs either in part of an Investment Policy Statement ("IPS") or in a separate document is acceptable. Many institutional investors have chosen to incorporate their Investment Beliefs Statements into their IPS. This location is convenient as an IPS is regularly reviewed and updated. Some decision-makers choose to present their Investment Beliefs Statement as a separate, standalone policy document. If a governing group decides to create a separate beliefs policy, they should update the IPS to reference the beliefs policy.

What are best practices for investment beliefs content?

Theresa Whitmarsh, Executive Director of the Washington State Investment Board, had this advice to share to other public pensions working through the development of investment beliefs:

> *"When done well, investment beliefs are specific enough to provide guidance and direction, but broad enough to be meaningful in all sorts of market conditions and for all asset classes, investment regions and investment disciplines. Investment beliefs are like a good compass – they must strike a delicate balance between directional strength and all-weather adaptability."*[6]

Each institution's governing group must determine what is best for its unique situation. A third party cannot and ought not to tell investors what they should believe. However, following the process previously described, an outside perspective can facilitate decision makers in their discovery and articulation of what they *do* believe.

[6] Via email conversation with Theresa Whitmarsh, June 2016.

Investment beliefs tend to fall into one of four categories:

1. Financial market beliefs
2. Investment process beliefs
3. Organizational/governance beliefs
4. Sustainability beliefs

Best practices dictate a minimum of five statements that address the following areas:

- → Risk diversification
- → Risk premiums
- → Long term horizon
- → Costs
- → Governance

Governing groups sometimes ask, "How many investment beliefs should we have?" Among public pensions, the range of beliefs statements tends to be between six and twelve individual principles. Some statements include a narrative with supporting explanations; others may include sub-statements that support the primary belief. All statements should be clear and concise with no room for interpretation.

What are some more commonly-shared investment beliefs?

In 2016, Meketa Investment Group conducted a comprehensive peer review of large public pensions across the U.S., Canada, U.K., and Australia. After reviewing hundreds of individual investment beliefs, we identified the following principles as being widely shared by large, public pension funds:

1. Financial Markets
   - → Markets are generally efficient over the long-term
   - → Risk should be rewarded appropriately
   - → Equities provide higher expected returns than most other security types
   - → Private markets/illiquid assets can add value
   - → Active management is justified in inefficient markets

2. Investment Process
   - → Asset allocation is a critical decision for stakeholders/staff
   - → Diversification enhances returns
   - → Costs materially affect returns
   - → Our portfolio should be forward looking

3. Organizational/Governance

→ We are long-term investors with a long-term investment horizon

→ Organizational knowledge should be supplemented with external expertise

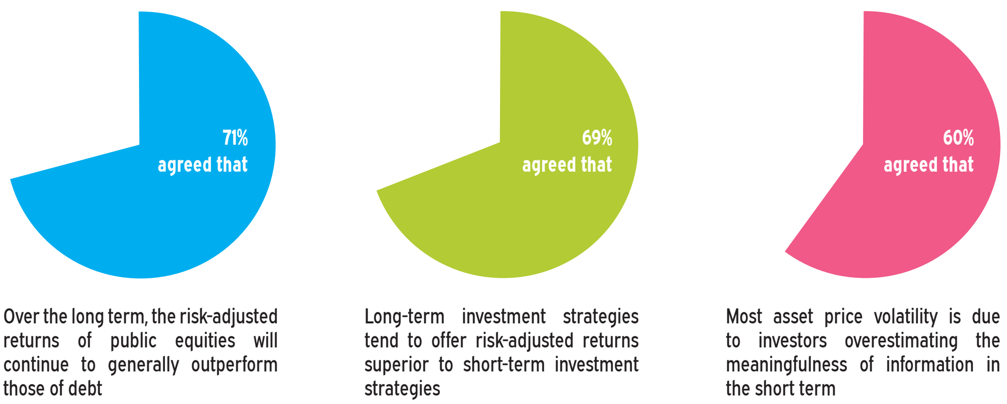
4. Sustainability

→ As long-term investors, the sustainability of our investments matters

Similarly, a survey conducted by Pensions & Investments/Oxford University highlighted some commonly held investment beliefs.[7] For example, institutional asset owners most strongly agreed that:

[7] Pensions & Investments (2012). Investment Beliefs Survey Results (joint study with Oxford University).

FIGURE 1



Conclusion

Institutional investors are increasingly adopting statements of investment beliefs to improve their decision-making. With a well-written and thoughtful set of investment beliefs, governing groups better position themselves to achieve their objectives as they make difficult investment choices. Clearly articulated investment beliefs can lead to better oversight, analysis, and decisions about investments, as well as increased understanding of the decision-making process by institutional investors.

Appendix

Frameworks for developing investment beliefs

Koedijk and Slager describe a three-step framework for developing investment beliefs, which is robust and academic. At its most basic, they suggest that stakeholders should:

1. Understand investment fundamentals
2. Explore investment beliefs
3. Embed beliefs into investment process

The UNPRI has an eight-stage process, four of which are applicable to pension plans seeking to draft a traditional investment beliefs statement. These stages and their corresponding action items include:

Getting started

→ Undertake a peer review of other public pensions' Investment Beliefs Statements
→ Create a plan to develop the policy
→ Set up a diverse task force; schedule time to complete the project

Writing your policy

→ Include an introduction
→ Include a definition of how the Stakeholders define "Investment Beliefs"
→ Articulate your investment beliefs

Reporting

→ Decide if/how you are going to measure the impact/performance of your beliefs statements

Reviewing the policy

→ Investment Beliefs Statements are dynamic documents and should be regularly reviewed

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