Case Study—Future Fund

Long-horizon fund, a master in managing agency issues, focus on the whole and not on the parts.

Background. The Australian Government Future Fund is an independently managed sovereign fund founded in 2006, financed with a capital injection of AUD 60 billion by the Australian government.[1] Future Fund had AUD 139 billion (approximately $102 billion) under management at the end of 2017. Its main purpose is to reach AUD 140 billion to meet liabilities for the payment of superannuation to retired public employees.[2] The benchmark is the Consumer Price Index (CPI) plus a percentage range of 4%–5% in 2017. The fund outsources almost 100% of the assets to external managers. Future Fund has a clear approach on how to manage the assets. It sees its long horizon as a key ingredient for generating high returns, for three reasons: (i) the ability to take on greater levels of market risk, under the assumption that a long-term investor is able to tolerate the shorter-term losses; (ii) the ability to accept capital being locked up in assets or structures that are costly to sell out of within a short period of time; and (iii) the ability to be countercyclical, patient and opportunistic. External managers execute the implementation of the strategy; this is due to the fund's founding legislation.[3]

Challenges. Future Fund has been very active in overcoming agency problems. David Neal, managing director of Future Fund, addresses four common agency problems that occur within a fund that could worsen performance[4]:

1. *Principal agent problem*. Short-term evaluation of performance should not be a common practice. "Good results tend be taken as confirmation that things are on track and the manager is skilled. Bad results foster doubt, and throw the onus of proof back on demonstrating that the manager is acting appropriately. When a manager senses they are being evaluated on short-term results, then delivering good short-term results is what they will work towards."
2. *Rewarding*. Too many rewards are linked to short-term performance. This creates an issue where short-term-minded managers are incentivized to follow long-term goals. But there is an issue that is subtler and more personal in nature, e.g. career prospects can be greatly improved by a solid recent performance history, which enhances the scope for being promoted, head-hunted, or for starting up an own fund.
3. *When things don't initially turn out as expected*. Both principal and agent will be trying to judge if a mistake has been made and the manager's position

should be terminated, versus whether the payoff has merely been delayed. The risk is that principals then act in ways that undermine capacity to invest for the long term. They may respond to noise rather than signal, incorrectly blame the manager, and either pressure them to stem the losses or replace them, or withdraw funds. Second, long-term investors that decide to do nothing due to their nature might create even bigger problems.

4. *Long-term commitment*. Success in the long run requires commitment from the principal in the fund and the manager. This, however, creates an agency problem for the manager and the commitment of funding sacrifices liquidity.

The process. Neal and Warren propose solutions to the agency issues they identify in their paper. They come up with four solutions:

Align the Organizational Settings. When everyone's compass in the fund is set in a collective direction, they will think and act in terms of long-term objectives. This can be achieved by explicitly writing down guiding principles such as mission, purpose, and belief statements; but also by working on culture by improving leadership, professionalism, and creating an environment of trust. In addition, "attention should be focused on whether outcomes are on track to achieve long-term goals, rather than period-by-period returns." To cope with myopic loss aversion, Neal and Warren suggest less frequent feedback and fewer opportunities to take action, encouraging team decision-making, and employing the right people who have affinity with long-term investing." Lastly, the above-mentioned solutions should be extended downwards to external managers to build partnerships based around mutual trust and respect. Contracts should be designed in such way in order to maintain long-lived relationships and fulfill the long-term objective.

Build Understanding through Engagement. A key strategy of Future Fund is engaging in a collective understanding among all stakeholders of investment decisions and outcome. This way, principals remain on the board and the strategy dilutes the tendency to monitor short-term results. Neal and Warren say: "Engagement means involving principals in decisions, rather than maintaining independence and distance. Engaging over investment decisions sits uncomfortably with the concept that there should be clear separation between governance and management. Engagement is a compromise that recognizes the deficiencies in monitoring by the flow of results when investing for the long term." Rather than having "distant monitoring," where there is distance between the different parts of the chain, the Fund uses what it calls "immersed monitoring," in which there is a deep and shared understanding about the investment decision being made in the different parts of the chain, e.g. between the board and the investment management organization.

Design of incentives. Financial incentives should not distract from the long term. The fund recognizes the problem of remuneration based on long-term rolling periods performance, but opts for a system of three-year rolling performance evaluation to align interest although this might not be in line with the realities of the employment market. An additional subjective component is explicitly used to reward actions that contribute to long-term outcomes, such as collaboration across the portfolio, challenging accepted ideas and orthodoxies, and building productive relationships. In this way, the remuneration structure focuses on portfolio performance, while giving ample consideration for the quality and sustainability of how performance is achieved.

Commit to the long term. "Demonstrating commitment to the manager themselves is a matter of placing faith and trust in them, and resisting holding them to account for short-term performance. The main caveat is that managers should be answerable for behaviours that deviate from the long-term mission and agreed-upon strategies. The aim is to foster the expectation of an extended career or relationship with the organization. Commitment might be demonstrated by not handing out terminations lightly; and giving consideration to the messaging around commitment when doing so."

The outcome. Future Fund is relatively young. It had the advantage of designing itself while taking into consideration how other funds have structured themselves. Future fund therefore puts much effort in managing the principal–agent problem and aligning interests of the people with the goals of the fund. Over time, the fund has made its beliefs more explicit and expanded the transparency and openness within the organization. Also, "The 'one portfolio' approach is central; and regardless of job function, remuneration for all employees is partly based on the entire portfolio performance, so that the portfolio is boosted by the alignment of everyone's interest."[5]

Since the size of the investment team is deliberately relatively small by design, it has the means to include all relevant people in the investment process, thereby avoiding silos in the organization. The staff of the firm is strongly encouraged to feed ideas; even the manager review committee and asset review committee feed ideas to the investment committee. The main idea is that an idea should enhance the portfolio. The staff is rewarded for supporting ideas that are not their own, thereby eliminating biases such as empire-building and silo-ing.

Lessons for Achieving Investment Excellence

- Future Fund is a master of recognizing and reducing agency issues between all the parties involved in the investment process.
- The tools to do so are predominantly qualitative in nature—creating a shared understanding and culture, and involvement along the whole organization, beginning with the board.
- It addresses long-horizon agency issues between the board and the investment management organization through "immersed monitoring."
- The people within the investment management organization are strongly aligned because of the "total fund perspective" and the fact that they are incentivized to the portfolio as a whole and not to parts of it.