

The Ambachtsheer Letter

Research and Commentary on Pension Governance, Finance and Investments

Letter # 272

September 2008

INVESTING FOR THE LONG RUN:

A 'MICRO' PERSPECTIVE

“Structural trends once consigned to the category of ‘interesting, but too long term’ are impacting the business environment increasingly quickly, leading to increasingly rapid turnover in industry structures and accelerating the pace with which competitive advantage is reflected in financial performance...”

“Long-Term Opportunities in a Changing World”
Goldman Sachs - Global
April 18, 2008

From 'Macro' to 'Micro'

Last month's 'macro' *Letter* concluded that “returns on most risky assets will likely be below their long run averages for some time yet”. The bases for this conclusion were the behavioral and institutional realities captured through the messy but realistic Adaptive Markets Hypothesis (AMH), and its 'real world' confirmation. The 20th Century actually experienced six market mindset eras, each 10-20 years in duration, which swung from pessimism to optimism, and back again. As a consequence, long term investment risk premiums swung from negative to positive, and back again. This actual experience is consistent with the AMH view of the world.

Last month's *Letter* also noted that despite this overhanging 'macro risk' cloud, individual and institutional investors can't just stop investing. Instead, the questions of what to invest in, and how to go about it, should be rethought. That is what this 'micro' *Letter* is about. Its plan is to address the 'what?' and 'how?' questions by pursuing the following logic stream:

- What insight does 'Integrative Investment Theory' offer into the questions?
- How will structural developments in the market for investment management services impact the answers?
- Do we need to rethink 'asset classes'?

- Do we need to rethink 'investment mandates'?
- In the context of these questions and their answers, what can we say about the investment opportunity set today, and its strategic implications?
- Why is 'investing for the long term' still more the exception than the rule?

We start with the insights provided by 'Integrative Investment Theory'.

Integrative Investment Theory

We have been arguing for quite some time that a complete theory of investing should deal with more than just return, risk, and efficient frontiers. It should also integrate the institutional factors that impact how investment decisions are actually made. We categorize these factors as either agency- or organization design-related:

- Agency factors include such issues as whether institutional structures and investment processes are free of conflicts of interest. If not, decisions relating to investment structure, and the cost of that structure, may not be made solely for the benefit of investors using the structure. The same will be true for investment decisions themselves. Agency issues can arise at both the individual investor (e.g., investment advisor) and collective (e.g., mutual