Give Investors Freedom to Focus on Long and Short-term Goals – Finland Pension Fund Head

Editor: Kathryn Saklatvala, Content Director, Institutional Investor

"Long-termism is not always good; short-termism is not always bad. ... Investors should be given the freedom to take a long or short-term perspective." So says Timo Löyttyniemi, Managing Director of Finland's State Pension Fund, who suggests three key ingredients that may help or hinder that goal: regulation on risk tolerance, benchmarking mechanisms and behavioural biases.

On November 26 in Paris, Löyttyniemi will be speaking at the **OECD / Euromoney Conferences Roundtable on Long-term Investment.** In a recent interview – available in full below – he shared his views on the key issues that delegates will discuss.

Highlights include:

- **The consequences of regulation**: "Solvency II and other [European] regulatory measures have had an undoubted effect on pension funds' ability to be long-term ... there has been a tendency for regulator activity to push pension funds towards bonds rather than equities." Yet there are differences between countries: "In Finland, regulatory authorities are now proposing changing their solvency calculations in a way that would enable pension funds here to accept somewhat more risk and take a longer view. "
- **Benchmarking challenges**: "It is often accepted that benchmark return is neutral. This approach does perhaps give us a long-term horizon since it gives us tolerance for market falls. Yet at the same time it introduces short-termism into our behaviour because our focus becomes directed towards beating the benchmark."
- **Why investors are shifting to unlisted assets**: "There is now less pressure for pension funds to invest in listed rather than unlisted markets. This is partly because unlisted instruments have developed significantly in terms of NAV and transparency. There are other factors encouraging investors towards unlisted opportunities, although perhaps we do not always think about or acknowledge them openly..."
- **Appetite for new vehicles, product types**: "One area of the unlisted markets that we're really interested in right now is private credit. At this stage, the only players are private equity-type funds with traditional LP-GP structures. We want to see new players, other types of middlemen, new financing vehicles. ... Infrastructure is another sector where we'd be keen to see more evergreen fund structures."

For information about this roundtable, email raffaele.dellacroce@oecd.org and costrowski@euromoneyplc.com.

In interview: Timo Löyttyniemi, Managing Director, Finland State Pension Fund

Long vs. short-termism

As pension funds, are we long-term or short-term investors? The truth is that we are - and should be - both. Long-termism is not always "good" and, equally, short-termism is not always "bad."

Protecting against downside risk in order to preserve capital, for example, is short-termist behaviour that can be very beneficial for the fund. On the other end of the spectrum, investors who stick to their benchmarks or allocations without questioning themselves when in fact the prospects may have changed may be demonstrating negative long-termist behaviour. We need to keep reviewing and challenging our own assumptions on issues such as geographical bias and expectations of long-term equity market performance.

Regulation and benchmarking

As far as possible, investors should be given the freedom to take a long or short-term perspective. There are three main ingredients involved:

1) The regulation on that particular investor, especially where its solvency status or other measures of risk tolerance are concerned.
2) The benchmarking mechanisms which govern that investor's actual activity, such the metrics used to assess performance or incentives.
3) The measures in place to address or counteract our behavioural biases or tendency to be more focused on the short-term, driven by news or market movements.

Solvency II and other regulatory measures have had an undoubted effect on pension funds' ability to be long-term. Of course this varies greatly depending on institution type: insurance funds are more strongly affected; a pension buffer fund such as ours, without direct pension liabilities, is less constrained. To some extent the new risk measures that are being implemented are still at an early stage, so it's hard to know the ultimate effects. Yet the tendency during the past seven or eight years does seem to be a movement towards pro-cyclicality. In terms of instruments, there has been a tendency for regulator activity to push pension funds towards bonds rather than equities. Different countries have taken different steps. In Finland, for example, the regulatory authorities are now proposing changing their solvency calculations in a way that would enable pension funds here to accept somewhat more risk and take a longer view.

Even if regulations permit appropriate flexibility for the investor, the fund's own governance can make a great difference. Board behaviour, investment team behaviour, manager behaviour and the various principal-agent gaps can affect long-termism. One theme that is perhaps not discussed by investors as much as it ought to be is the use of benchmarks. It's often accepted that benchmark return is "neutral." We, for example, use about 20 benchmarks that are all market cap based. This approach does perhaps give us a long-term horizon since it gives us tolerance for market falls. Yet at the same time it introduces short-termism into our behaviour because our focus becomes directed towards beating the benchmark, even a little, over relatively short periods of time. Frankly, whether we're 10bps above or below the benchmark isn't very important.

Asset allocation

One shift that seems to have happened gradually during recent years is that there is now less pressure for pension funds to invest in listed rather than unlisted markets. This is partly because unlisted instruments have developed significantly in terms of NAV and transparency.

There are other factors encouraging investors towards unlisted opportunities, although perhaps we do not always think about or acknowledge them openly. For example, an investor might rationally choose to invest a portion of assets in private equity rather than public equity even if the returns were exactly the same on each side, because the reporting period - quarterly or less often - produces an apparent volatility reduction. Of course the investor in that case would know that the underlying risks were the same or higher, but the perceived risk according to the measures we're required to use would be lower.

One area of the unlisted markets that we're really interested in right now is private credit. Two years ago we decided to introduce this as an asset class in our portfolio. Banks have been squeezed by regulatory authorities to diminish risk-taking on their balance sheets and hold more equity capital, lessening the opportunities for companies to get financing. This has opened up an avenue for private credit funds to exploit. We've committed 3-500 million euros to this space but have invested much less than that, in about ten funds so far - old fashioned mezzanine-type funds, senior loans and some more towards the distressed end.

My strong feeling is that we are going to see the development of new professional actors packaging credit lines in new types of financial institutions. At this stage, the only players are private equity-type funds with traditional LP-GP structures. We want to see new players, new types of middlemen, new financing vehicles. What I'd really like is a senior loan type of portfolio. It would also be good to see evergreen structures rather than traditional private equity, which is a more short-term aggressive approach. Greater standardisation is also important to the development of this asset class.

Infrastructure is another sector where we'd be keen to see more evergreen fund structures, since we invest in this space via funds rather than directly. We're also in the process of seeking more co-investment. One important aspect of infrastructure investing which is not always well understood is the importance of the packaging. The risk characteristics may change significantly. Investors expecting a steady cashflow from such investments may end up surprised. It's vital to look deeper.

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