

Do Institutional Investors Have Sensible Investment Beliefs?

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This article investigates the building blocks to successful investment strategies for institutional investors. It presents the results of a worldwide survey of investment beliefs, and finds striking differences in how pension funds and commercial asset managers view capital markets. Asset managers seem to use their investment beliefs to demonstrate their competitive advantage to current and potential clients. Pension funds, on the other hand, seem to use formulated investment beliefs as a tool for decision-making. We link investment beliefs to performance measures and find that pension funds with clear beliefs about asset pricing and risk diversification have better return/risk performance measures, as well as lower costs.

Keywords: Investment Beliefs, Investment Strategy, Pension Fund, Pension Fund Governance, Performance.

The Value of Investment Beliefs

The financial crisis is severely testing the investment models of pension funds. Static investment policies, supported by static beliefs about return distributions and equity risk premiums are being questioned. The need to take a strategic management approach to investment process design has never been more urgent. Outside the sphere of pension fund management, strategic management is commonplace. The success of firms such as eBay and Amazon is often attributed to the way they use new technologies, which do not simply make operations more efficient but create new business models altogether (Gurley, 2001). Arguably, pension funds can no longer avoid having a critical look at their own business models.

Authors such as Clark and Urwin (2007), and Ambachtsheer (1998 and 2007), have pioneered the strategic management approach for the pension fund industry with convincing arguments. In the long-term, well-governed pension funds might increase returns by one to two percent per year as compared with other funds. This article frames pension funds in a strategic management context and focuses specifically on their respective investment beliefs.¹ What does the fund do to add real value for its clients in capital markets? Is there a clear view on how capital markets function? Investment beliefs are important because these create context for value-creating investing (Ambachtsheer, 2007). What are the core competencies of an investment organization which aims for success in capital markets? We address a strategic question

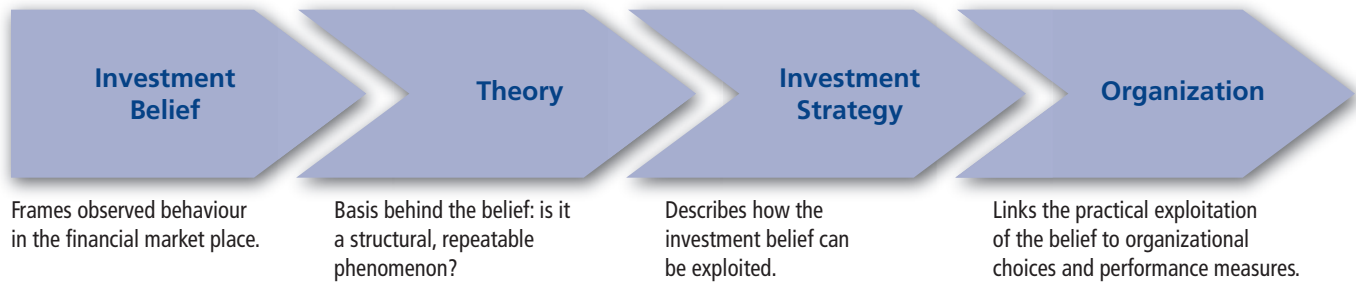
that seems obvious, but to date has seldom been discussed in strategy and investment literature.

A Primer on Investment Beliefs

Investment theory and practice have evolved dramatically over the past five decades, yet no objective framework exists that adequately describes how we view capital markets, or how to apply these insights for investment purposes (Lo, 2005). Investment beliefs accept this reality and usually contain a view on how market participants learn, or fail to learn, from experience. Consider how investors value securities by discounting their future cash flows and comparing them to current prices (Minahan, 2006). The trading strategy is straightforward: buy, if value is higher than price, and sell, if value is lower than price. In real life, the failure to do this successfully through active management is well documented. Human judgment and behaviour often stand in the way of an objective valuation and trading strategy. One does not know the future cash flows of the security, nor is there agreement about the discount rate to be applied. To make matters worse, if the security is an illiquid asset, determining the current price is the result of an arbitrary valuation. Failing to create an objective assessment, coupled with news about the security issuer, creates further noise when investors hold different views, as extensively documented by behavioural finance.

This article will not explain *why* markets are not able to reach consensus on future cash flows or discount rates. Rather, it will

Figure 1: Framework for Analyzing Investment Beliefs



focus on whether an investment manager can have consistent views on mis-pricing and exploit these. This is the basis for a workable investment process, consisting of four elements shown in Figure 1. Within this framework, an investment belief is a statement about human behaviour in the financial marketplace, such as ‘markets overreact’. Investment theory indicates whether there is a theoretical basis for holding such an investment belief. What causes mis-pricing? Is it a structural phenomenon that repeats itself? If observed phenomena in financial markets have no sound theoretical basis, then the investment organization runs the risk of designing a strategy around a mechanism without any predictive content. The investment strategy element in Figure 1 describes how the investment belief can be exploited. With market overreaction, an exploitable strategy is to sell stocks after a positive news announcement and buy them when the opposite happens. Finally, the organization addresses the practical issues that must be dealt with to exploit the investment strategy successfully. For example, the investment process links the exploitation of stated investment beliefs to performance measures, which in turn, relates directly back to the investment belief.

Table 1 provides an example. If all four process elements can be applied, then there is an exploitable investment belief in place. If even one of the boxes cannot be determined or implemented, the investment belief is flawed. Implementing a strategy based on a belief without a clear reason is like betting on the lottery. Alternatively, not thinking through organizational aspects also has its drawbacks. For example, Shell Pension Fund argues that when minimizing implementation costs are ignored, it becomes very hard to outperform through classic stock picking (Bartlema, 2005). Consultant firm Analytics argues that many managers potentially have the skills, but fail to realize outperformance, due to flawed implementation (Greene, 2007). The investment belief itself should not be a reflection of consensus. It must stand out as a belief that is distinct from the beliefs of many other market participants. The fact that the relationship between risk and return represents an upward slope is no surprise to market participants. The view that there are unique risk-return opportunities that only pension funds can exploit is the basis for a valuable belief.

An investment philosophy is a dynamic set of core investment beliefs that an asset management organization considers fundamental to how it structures its investment process, including the integration of elements such as risk aversion, time horizon, and asset size. Having this structure in place greatly simplifies the lives of Trustees and fund executives by permitting them to clearly evaluate the effectiveness of investment managers and investment strategies. Without a coherent investment philosophy, Trustees and fund executives will find themselves lacking a rudder and become easy prey for investment banks, consultants, and asset managers, each claiming to have found the magic strategy that beats the market. Today’s buzzwords in financial markets are liability-driven investing, portable alpha, exotic beta, sustainable responsible investing (SRI), absolute return strategies, 130/30 strategies, and fiduciary management. Which of these are relevant for a fund and why? Without strong investment beliefs, a pension fund might end up with strategies that are inappropriate for its participants. In short, with clear beliefs, Trustees and pension executives can make better-informed decisions and are more likely to add value.

Table 1: An Example: ‘Overreaction’ as an Investment Belief

<input checked="" type="checkbox"/> Belief	Investors overreact to news
<input checked="" type="checkbox"/> Theory	Stocks that have had bad news announcements will be underpriced relative to stocks that have had good news announcements.
<input checked="" type="checkbox"/> Strategy	Buy (sell short) stocks after bad (good) earnings announcements. Alternatively, buy (sell short) stocks after big stock price declines (increases).
<input checked="" type="checkbox"/> Organization	Trading strategy with short-term horizon. Good versus bad news announcements have to be identified.

Source: Drawn from Damodaran (2007)

How Popular are Investment Beliefs? An Investigation

American asset manager Vanguard believes in low cost and index replication. Canadian endowment fund Edmonton Tel considers strategic asset allocation as its main decision-making tool, whereas Swiss private bank Pictet uses a bottom-up approach for security selection. There are some interesting nuances to these beliefs. Tactical asset allocation is crucial for Danish pension insurer PensionDanmark, whereas Edmonton Tel believes that limited value is realized from tactical asset allocation shifts. Clearly, these organizations hold widely differing investment beliefs. To gain more insight into these beliefs, we developed a dataset of forty pension funds and asset managers with publicly-reported investment beliefs.²

The dataset was compiled from websites and publicly-available annual reports of pension funds worldwide, looking for sections describing their investment philosophy, added value, or investment beliefs. The list of pension funds derived from the *Pension & Investments Databook 2007* is organized by asset size for 2006. Of the three hundred funds, we found fourteen funds that publish this information. Selecting from the three hundred largest funds resulted in a size bias, meaning the neglect of smaller organizations. So we analyzed other pension plans and endowment funds outside the top three hundred for their investment beliefs and philosophies. We found investment beliefs for nine additional funds.

To enhance the robustness of the data, we further expanded it to include seventeen institutional asset managers as the main

suppliers of investment management for pension funds based on the *Pension & Investments Databook 2007*. This allowed us to check for distinguishing characteristics of pension funds by comparing them to asset managers. Table 2 summarizes the characteristics of the firms in our sample. The publication of investment beliefs is concentrated in Canada, United States, the Netherlands, Australia, Denmark, and Sweden. The selection of countries might raise issues around selection bias, but these are mitigated since the majority of the world's pension assets are also concentrated in these countries. Also, public pension plans rather than corporate pension plans tend to publish investment beliefs, reflecting a higher demand for transparency of these types of funds.

Our survey identified twelve categories of beliefs for both pension funds and asset managers (Table 3). These were further categorized into four broader sets of beliefs (cf. Ambachtsheer, 2004, 2007; Koedijk and Slager, 2007). The first broad set addressed financial markets beliefs and the second set considered sources of added value in the investment process. We also identified beliefs about the firm's own organizational skills and factors such as sustainability and corporate governance. Table 4 presents the results of the survey conducted around investment beliefs. The results are published separately for pension funds and asset managers, offering a stylized picture of the differences between the two. We note that pension funds tend to interpret the consequences of risk premiums in financial markets and emphasize the importance of risk diversification. Both beliefs are consistent with taking a long-term view of investment management.

Table 2: Summary Statistics and Regional Distribution of Dataset

Country	Asset Managers			Pension Plans			Total		
	Total Assets	Col %	N	Total Assets	Col %	N	Total Assets	Col %	N
Australia	-			33,721	2.2%	2	33,721	0.3%	2
New Zealand	-			7,121		1	7,121	0.1%	1
Canada	-			241,669	15.7%	7	241,669	2.3%	7
United States	3,634,751	41.5%	7	407,479	26.5%	4	4,042,230	39.2%	11
Denmark	-			73,655	4.8%	2	73,655	0.7%	2
Germany	1,026,875	11.7%	1	-			1,026,875	10.0%	1
Netherlands	904,464	10.3%	3	397,840	25.8%	4	1,302,304	12.6%	7
Norway	-			235,849	15.3%	1	235,849	2.3%	1
Sweden	-			93,861	6.1%	1	93,861	0.9%	1
Switzerland	2,084,013	23.8%	2	-			2,084,013	20.2%	2
United Kingdom	1,117,958	12.8%	4	48,416	3.1%	1	1,166,374	11.3%	5
Total	8,768,061	100.0%	17	1,539,611	100.0%	23	10,307,672	100.0%	40
Minimum	623			2,000			623		
Quartile 1	8,473			105,885			16,973		
Quartile 2	34,536			269,493			81,122		
Quartile 3	81,122			647,867			244,260		
Maximum	367,939			2,016,000			2,016,000		

Source: *Pension & Investments Databook 2007*, augmented with annual report data. Assets are stated in millions of US dollars.

Table 3: Stated Investment Beliefs

Belief	Rationale	Example
Inefficiencies	Is the pricing of securities (and/or in aggregate the market or asset category) perfectly efficient or less than perfectly efficient? If they are less than perfectly efficient, what is the inefficiency?	Vanguard finds that “consistently outperforming the financial markets is extremely difficult.” Pictet holds a bottom-up approach, believing that “the price of a financial asset should reflect the present value of its future cash flows.”
Risk Premium	The (equity) risk premium plays an important part in the amount of risk an investor has to bear. The assessment of what level the risk premiums are in the future heavily determines the asset allocation of the pension fund.	The New Zealand Superannuation Fund believes that it should “exploit the premium available to investors who do not require liquidity. Our long investment horizon . . . means we are extremely well positioned to capture this premium.”
Risk Diversification	Diversification among assets is an essential instrument to create portfolios with a lower expected risk given the target return. Views on diversification are shifting; correlation does not hold in periods of extreme volatility. Investment managers increasingly look to add new — alternative — investments to uphold diversification advantages.	The New Zealand Superannuation Fund believes that “risk and return are strongly related and that diversification reduces total risk. Combining lowly correlated assets to deliver stable returns is critical to their success.”
Investment Horizon	Long-horizon processes focus on projecting and valuing uncertain future cash flows and are positive-sum games. Statistically, the longer the investment period, the smaller the standard error of the estimated return becomes, improving valuation and performance opportunities (Guyatt, 2005).	Pension fund PGGM “capitalizes on its strength as a long-term investor . . . It can select investments which generate a high return in the long-term, even though they may suffer short-term losses.”
Focus and Impact Decisions	The focus on asset allocation is a key element, reflecting research that the asset allocation decision between asset classes may play a greater role than the tactical movements of holdings within asset classes in shaping risk and performance.	The Alberta Workers Compensation Fund finds that “Asset allocation is the most determining factor in the investment performance of the Fund.”
Risk Management	Although risk as a separate belief is embedded in the financial market beliefs in the form of risk/return relationship, <i>risk management</i> addresses a broader range than just securities. More specifically, it addresses the implementation and monitoring of the investment process.	The OMERS Board believes that “capital markets and risk processes will continue to evolve and, as such, encourages investment staff to investigate, understand and use, where applicable, new strategies and asset classes to enhance the Fund’s value or mitigate risk.”
Investment Management Style	Investment managers usually describe their activities as having a ‘style’ that describes their approach to investing. Pension funds and asset managers adhere to a wide range of active and passive management styles.	For ABP, Alpha generates a valuable contribution to the return: “Generating ‘alpha’ . . . yields a valuable contribution to the return on the portfolio, with little increase of the overall risk.”
Costs	All other things equal, lower investment costs are always better than higher investment costs. Avoiding high cost assets (such as private equity or hedge funds) or focusing on low-cost strategies in large, liquid, efficient markets can form an alternative investment belief.	Vanguard believes that “minimizing the cost of investing is vital for long-term investment success.”
Organizational Beliefs	Organizational setup, focus on the role of teams.	HSBC asset management believes “that the best results are delivered by small teams of portfolio managers who are focused, empowered, and accountable.”
In/Outsourcing	Outsourcing asset management should improve investment returns, since outside investment managers are likely to bring superior professional experience and skills to the pension plan investment decisions. Moreover, contracting (outsourcing) allows a retirement system to change its investment managers more readily in response to poor performance.	The Victorian Fund Management Corporation outsources fund management “with the skills of the in-house investment team focused on selecting the best in class providers and then building asset class portfolios as efficiently as possible. As we expand into alternative asset classes we may review this model since it may be more effective to bring various activities in-house.”
Corporate Governance	Good corporate governance is related to strong profitability and investment performance measures. Efforts by investment funds to improve the governance of companies that are considered poorly governed produce good returns in excess of market performance.	Hermes’ approach is based on the belief that “companies with concerned and involved shareholders are more likely to achieve superior long-term returns than those without.” Active shareowner involvement could remedy consistently underperforming companies as a result of structural or strategic governance weaknesses.
Sustainability	Sustainable investors believe that companies with adequate sustainable policies deliver on average superior earnings and will be rewarded with above-average investment returns. Sustainable investments seem to provide at least comparable risk/return characteristics to ‘normal’ investments.	OMERS believes that “well-managed companies are those that demonstrate respect for their employees, the environment, the communities in which they do business, and for human rights, as well as meeting financial standards.”

Table 4: Summary of Stated Investment Beliefs

	Organization Type					
	Pension Fund		Asset Manager		Total	
	Count	Column %	Count	Column %	Count	Column %
Financial Markets						
Risk premium	10	6.4%	2	2.5%	12	5.1%
Risk diversification	14	9.0%	2	2.5%	16	6.8%
(In)efficiencies in financial markets /asset pricing	9	5.8%	12	15.0%	21	8.9%
Horizon	10	6.4%	4	5.0%	14	5.9%
	43	27.6%	20	25.0%	63	26.7%
Investment Process Beliefs						
Impact, focus of management decisions	34	21.8%	15	18.8%	49	20.8%
Risk management	6	3.8%	6	7.5%	12	5.1%
Investment management style	25	16.0%	14	17.5%	39	16.5%
Costs	2	1.3%	1	1.3%	3	1.3%
	67	42.9%	36	45.0%	103	43.6%
Organizational Beliefs						
Teams, role of investment managers	9	5.8%	13	16.3%	22	9.3%
Out vs. insourcing	5	3.2%	0	0.0%	5	2.1%
Experience	1	0.6%	3	3.8%	4	1.7%
Other	5	3.2%	3	3.8%	8	3.4%
	20	12.8%	19	23.8%	39	16.5%
Sustainability and Corporate Governance						
Sust. and Corp. Gov. in asset pricing	4	2.6%	0	0.0%	4	1.7%
Role in investment process	5	3.2%	1	1.3%	6	2.5%
	9	5.8%	1	1.3%	10	4.2%
Other Beliefs						
Pension liabilities	7	4.5%	1	1.3%	8	3.4%
Goal	3	1.9%	1	1.3%	4	1.7%
Other	7	4.5%	2	2.5%	9	3.8%
	17	10.9%	4	5.0%	21	8.9%
Total Count	156	100.0%	80	100.0%	236	100.0%

Pension funds and asset managers express comparable beliefs on their investment processes. Pension funds tend to stress what decision has the greatest effect, whereas asset managers tend to emphasize the role of risk management as the basis for investment style. Asset managers also tend to emphasize their views on asset pricing, which makes sense, since views on asset pricing offer a basis for active management. Asset managers also tend to stress the importance of their organizational qualities, especially the value of investment teams. This suggests that asset managers use their investment beliefs to position themselves in the investment management market. Finally, some pension funds emphasize the role of environmental, social, and corporate governance (ESG) factors in their investment philosophy and other beliefs that relate to organizational goals. Overall, the survey suggests that asset managers use investment beliefs to demonstrate their competitive advantage, while funds as principals formulate investment beliefs as an effective tool for decision-making, mitigating potential informational problems stemming from a principal-agent relationship between trustees and investors (cf. Clark and Urwin, 2007; Laboul and Yermo, 2006).

Association Between Investment Beliefs

The statistical relationships between investment beliefs are shown in Table 5, which shows the phi correlation statistics for the structure of investment beliefs.³ In theory, each investment belief should be independently formulated and not connected with other beliefs. The correlation statistics in Table 5 identify several significant relationships. For example, there is a positive association ($\phi = 0.26$) between the focus of management decisions on one hand, and beliefs about insourcing and outsourcing on the other. Organizations that hold beliefs about where their added value comes from tend to apply these in the investment process. There is also a positive relationship between beliefs about costs and the investment horizon in financial markets ($\phi = 0.43$). This likely reflects the view that the effect of lower costs becomes more visible with a longer time horizon.

Pension funds with beliefs about insourcing and outsourcing indicate fewer beliefs about financial markets such as risk diversification ($\phi = -0.26$) and inefficiencies ($\phi = -0.29$).

Table 5: Associations Between Investments Beliefs

			(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Investment process	Focus of man. decisions	(1)	1.0000								
Investment process	Risk management	(2)	0.0308	1.0000							
Investment process	Investment man. style	(3)	0.1281	0.1260	1.0000						
Investment process	Costs	(4)	0.1976	-0.1644	-0.0207	1.0000					
Organizational	Teams, role of investment man.	(5)	0.1647	0.2044	0.2318	0.1392	1.0000				
Organizational	Out vs. insourcing	(6)	0.2623 *	-0.0436	-0.0825	-0.1076	-0.0191	1.0000			
Organizational	Experience	(7)	0.0534	0.0000	0.0364	0.2215	0.3877 **	0.1260	1.0000		
Organizational	Other	(8)	0.0534	-0.1925	-0.3273 **	0.2215	0.2191	-0.1260	0.1667	1.0000	
Financial markets	Risk premium	(9)	-0.1703	-0.0970	-0.0855	0.0372	0.0368	-0.2328	-0.0187	-0.0187	1.0000
Financial markets	Risk diversification	(10)	-0.2023	-0.0308	-0.2446	0.2077	-0.1647	-0.2623 *	-0.0534	0.1245	0.4094 **
Financial markets	(In)efficiencies	(11)	-0.0138	0.0298	0.0563	-0.0245	-0.0392	-0.2928 *	-0.0861	-0.0861	0.2168
Financial markets	Horizon	(12)	0.1048	0.0000	-0.0476	0.4350 **	0.2097	0.2474	0.3273 **	-0.0364	0.0855
Other	Pension liabilities	(13)	0.2623 *	0.1309	-0.2474	-0.1076	-0.0191	0.3143 **	0.1260	0.1260	-0.0635
Other	Goal	(14)	0.1976	0.0548	-0.0207	-0.0811	-0.2448	0.4664 **	-0.0949	-0.0949	-0.1754
Other	Other	(15)	-0.1245	0.1925	-0.1455	0.2215	-0.2866 *	-0.1260	-0.1111	-0.1111	-0.2053
Sust. and Corp.Gov.	Sust. and Corp. Gov. in asset pricing	(16)	-0.0051	0.2740 *	-0.0207	-0.0811	0.1392	0.1794	0.2215	-0.0949	0.2498
Sust. and Corp.Gov.	Role in investment process	(17)	0.0534	-0.1925	0.2182	0.2215	0.3877 **	-0.1260	-0.1111	-0.1111	0.3546 **

			(10)	(11)	(12)	(13)	(14)	(15)	(16)	(17)
Investment process	Focus of man. decisions	(1)								
Investment process	Risk management	(2)								
Investment process	Investment man. style	(3)								
Investment process	Costs	(4)								
Organizational	Teams, role of investment man.	(5)								
Organizational	Out vs. insourcing	(6)								
Organizational	Experience	(7)								
Organizational	Other	(8)								
Financial markets	Risk premium	(9)								
Financial markets	Risk diversification	(10)	1.0000							
Financial markets	(In)efficiencies	(11)	-0.0965	1.0000						
Financial markets	Horizon	(12)	0.0116	-0.0563	1.0000					
Other	Pension liabilities	(13)	0.0605	0.0195	-0.0825	1.0000				
Other	Goal	(14)	-0.1976	-0.2206	0.0207	-0.1076	1.0000			
Other	Other	(15)	0.1245	-0.0861	0.1455	-0.1260	-0.0949	1.0000		
Sust. and Corp.Gov.	Sust. and Corp. Gov. in asset pricing	(16)	0.2077	-0.0245	0.2278	0.1794	-0.0811	-0.0949	1.000	
Sust. and Corp.Gov.	Role in investment process	(17)	0.1245	-0.0861	0.1455	-0.1260	-0.0949	-0.1111	-0.0949	1.0000

Note: the table shows the association between the different investment beliefs variables, measured by phi. *: p value < 0.1; **: p value < 0.05. N=40

In other words, beliefs about risk diversification and inefficiencies are sometimes passed on to external managers that pension funds select. On the other hand, pension funds with beliefs about insourcing and outsourcing are more focused on the organizational goals ($\phi = 0.46$) and pension liabilities ($\phi = 0.31$). Finally, beliefs about risk premiums are related to beliefs about risk diversification ($\phi = 0.40$), as well as beliefs about the role of sustainability and corporate governance in the investment process. Overall, these correlations suggest that the surveyed pension funds and asset managers have developed well thought-out investment beliefs, linking organizational goals, and beliefs about financial markets in a sensible way.

Linking Investment Beliefs to Performance Measures

Since investment performance varies across pension funds and asset managers, it would be useful to know if financial success can be linked to structural principles (cf. Mauboussin, 2006; Swensen, 2000) as embedded in the investment beliefs. The

relationship between objectives, strategy, and performance in investment management is a broad one (see for example Clark and Urwin, 2007). We do not pretend to cover the intricacies of these relationships. Instead, Table 6 tests some quantifiable measures that can be directly related to investment beliefs such as costs, risk diversification, investment management style and horizon. Again, the data collected from annual reports and the assets under management data for asset managers were retrieved from the Center for Research in Security Prices (CRSP) Mutual Fund database.

To examine if there is a relationship between investment beliefs and performance measures, Table 7 performs t-tests for equality of means for the performance measures, testing if having an investment belief significantly affects the performance measure. Two results stand out. Holding strong investment beliefs about risk diversification are related to an improvement in the return-risk ratio of the organization, related to realizing higher alpha, and lowering costs. On the other hand, cost, as a belief by itself, is not a differentiating element for the performance measures.

Table 6: Description of Metrics

Belief	Performance Measure	Construction
Risk Diversification	Return/ Risk Ratio	The return/risk ratio is the average yearly return divided by the yearly standard deviation, and focuses on the portfolio construction. The effect of superior strategic allocation and diversification strategies should be reflected to a certain extent in this measure. Superior strategic allocation and diversification also shows up through the concentration of assets.
	Asset Diversification	If diversification is crucial, assets are more likely to be allocated over different asset categories. Asset diversification is proxied through the Herfindahl index, the sum of squared asset allocation weights for a portfolio, ranging from close to 0 (relatively diversified) to 1 (highly undiversified). ⁴
Horizon	Comparison of Performance Measures for 3, 5, and 8 Years	
Investment Management Style	Alpha	Alpha measures the yearly return compared to the organizational benchmark (or policy) portfolio return, aggregating the performance effect of active investment choices such as tactical allocation, as well as manager selection. Alpha represents the successful exploitation of inefficiencies in financial markets.
	Information Ratio	The information ratio measures the results of active management controlled for the additional risk taken, calculated as alpha divided by the ratio of the standard deviation of alpha. Yearly figures have been used.
Costs	Expense Ratio	The expense ratio measures total cost, divided by the fund's total assets, as a proxy for competences of the organization. Does the organization have a clear view about its cost base and procurement process? Which activities are kept inside and which are outsourced?

Table 7: Mean Differences t-tests in Selected Performance Measures Between Reported and Non-Reported Investment Beliefs

Investment Belief	Asset Diversification			Return / Risk Ratio			Alpha			Information Ratio			Expense Ratio		
	2006	2003	2001	3 year	5 year	8 year	3 year	5 year	8 year	3 year	5 year	8 year	3 year	5 year	8 year
Focus of Decisions	-0.061	-0.112*	-0.072	0.865	0.380	0.213	-0.441	-0.375	-0.145	-2.796*	-0.177	-0.243	-0.204	-0.206	-0.213
Risk Management	-0.026	-0.027	-0.002	-0.131	0.005	0.163	0.464	0.081	0.093	0.997	0.080	0.243	0.109	0.118	0.113
Investment Style	-0.035	0.065	0.012	1.091	0.167	0.042	0.604	0.108	0.057	0.626	0.334	0.403*	0.102	0.081	0.049
Costs	0.011	0.080	0.045	-1.905	-0.208	-0.181	0.563	0.209	0.254	-1.204	0.026	-0.141	-0.274	-0.261	-0.258
Teams, Role of Man.	0.062	0.085*	0.024	-1.996	-0.247	0.021	0.053	-0.167	-0.053	-0.393	-0.086	0.125	0.196	0.193	0.172
Out vs. Insourcing	0.002	0.001	0.004	2.347	-0.080	0.076	-0.166	-0.220	-0.369	0.083	-0.185	-0.093	-0.264	-0.264	-0.283
Experience	0.060	0.125	0.170*	-1.612	-0.360	-0.228	1.559*	0.166	0.197	5.638*	-0.617	-0.322	0.301	0.315	0.265
Risk Premium	-0.063	0.025	-0.008	0.478	0.317	0.495**	0.017	0.271	0.224	-1.858	0.244	0.310	0.151	0.158	0.149
Risk Diversification	-0.078	0.028	0.045	1.018	0.780**	0.523**	0.412	0.513*	0.496**	0.873	0.339	0.147	-0.389**	-0.398**	-0.408**
(In)efficiencies	-0.026	0.026	-0.002	-0.961	-0.122	-0.006	-0.231	0.173	0.091	-1.777	0.285	0.431	0.248	0.259	0.280
Horizon	-0.010	0.083	0.006	0.630	-0.069	0.068	0.205	-0.017	-0.036	0.503	-0.225	-0.064	0.019	0.036	0.031
Asset Pricing	-0.022	0.056	0.170*	-1.379	0.689	0.949**	0.713	0.359	0.365	2.250	-0.124	0.112	-0.045	-0.037	-0.078
Role in Inv. Proc.	-0.050	0.098	-0.028	1.639	0.103	0.234	0.241	0.361	0.279	-1.153	0.321	0.278	-0.271	-0.295	-0.321
df	29	16	14	27	27	27	14	14	14	12	12	12	25	25	25

Means t-test for equality of means, equal variances assumed. Significance 2 tailed. *: p value < 0.1, **: p value < 0.05. Alpha is measured in %, expense ratio in basis points.

Having clear views on efficiencies or inefficiencies in financial markets has no relation to any of the performance measures. This raises the question of whether or not planned strategies are executed properly, if at all. Similarly, time horizon has no relation to the performance measures. Holding strong views on the time horizon probably influences the views toward risk diversification, given the relatively strong correlation ($\phi = 0.41$) between those two investment beliefs in Table 7. The results show interesting relationships between performance measures and isolated beliefs, but more research is needed to draw generalized conclusions. For example, the process of formulating investment beliefs for well-governed funds might have a stronger effect on performance measures, rather than the combination of isolated effects of investment beliefs on performance measures.

Focus Pays Off

Developing thoughtful investment beliefs is an important strategic step for investment organizations. Without such beliefs, Trustees and investment managers run the risk of assessing new investment strategies and making changes on an ad-hoc basis, potentially creating suboptimal results. Such beliefs are also important from a pension fund governance and principal-agent point of view. Commercial asset managers use investment beliefs to demonstrate their competitive advantage. Pension funds, acting as principals, formulate investment beliefs as an effective tool for decision-making. Throughout our survey, we discovered that the publication of investment beliefs is still a relatively rare phenomenon. This seems odd, considering that investment management is a core competency for pension funds and asset managers. On the bright side, our findings suggest there is ample room for improvement.

The survey organized investment beliefs into four categories: beliefs about financial markets (e.g., risk premium, diversification, and time horizon), investment process (e.g., risk management, and investment style), organization (e.g., teams, insourcing or outsourcing, and role of experience), and ESG factors (e.g., the effect of sustainability and corporate governance on asset pricing, and its role in the investment process). Survey results suggest

differences in investment focus between pension funds and asset managers. Pension funds tend to focus on getting risk exposure right. They consider expected risk premiums in determining investment strategies and emphasize risk diversification. Both beliefs are consistent with a long-term view in investment management.

Pension funds and asset managers place comparable emphasis on their investment processes. Pension funds tend to favour decisions that have the greatest impact, while asset managers tend to emphasize their particular investment style. Asset managers also focus on asset pricing expertise and the value of teams as the basis for active management. This is likely part of their positioning strategy in the investment management market. Some pension funds, on the other hand, emphasize the role of sustainability in their investment philosophy and other beliefs related to their organizational goals.

There also seems to be a link between several investment beliefs and structural performance measures. We found evidence that organizations with investment beliefs on risk diversification showed better return/risk performance measures, as well as lower costs. The implication is that focus pays off. Funds that hold a clear view on how risk management is organized, usually in combination with a view on its management style, realize higher alpha and return/risk ratios than funds that do not hold such views.

This initial analysis suggests that further study in the area of investment beliefs could produce a large payoff. There are thousands of asset managers and pension funds in the world, yet only a few publish their investment beliefs. With further research, implicit investment beliefs could be made explicit, allowing us to confirm our preliminary findings in a broader setting. Refining the performance measures that link investment strategy with execution, while also embedding elements of a fund's governance structure, will help us answer further questions about what investment beliefs are productive, and those that are not. This will further aid pension funds in fine-tuning or redesigning their investment management and business models.

Endnotes

1. This article is based on an earlier paper presented at a joint Discussion Forum sponsored by the Rotman International Centre for Pension Management (ICPM), Network for Studies on Pensions, Ageing and Retirement (Netspar), and the University of Maastricht Business School. We are grateful to Keith Ambachtsheer, the Forum participants, as well as article reviewers Roger Urwin and Jack Gray, for their constructive comments and suggestions.
2. The surveyed funds and asset managers were, clustered by country, from Australia (State Super Financial Services Australia, Victorian Fund Management Corporation), Canada (Alberta Local Authorities Pension Plan, Canada Pension Plan Investment Board, Edmonton Tel Endowment Fund, Ontario Municipal Employees Retirement System, Ontario Teachers' Pension Plan, Public Employees Benefits Agency, Workers' Compensation Board Alberta), Denmark (ATP, PensionDenmark), Germany (Deutsche Asset Management), the Netherlands (ABN Amro Asset Management, ABP, ING Asset Management, Interpolis Insurance, Metalektro, PGGM, Shell Pension Fund), New Zealand (NZ Superannuation Fund), Norway (Norges Bank

Investment Management), Sweden (AP Fonden), Switzerland (Pictet, UBS), United Kingdom (Axa Rosenberg, Foreign & Colonial Asset Management, Hermes, HSBC Asset Management, Schroder Investment, University Superannuation Scheme), and United States (Capital Group, DGAM, Goldman Sachs Asset Management, MOSERS, Nebraska Investment Council, Northern Trust, T. Rowe Price, TIAA-CREF, Vanguard, Yale Endowment Fund)

3. The investment belief variables are dichotomous (they either are reported or not). Therefore, the phi values are shown, a chi-square-based measure of association that is often used as a measure of association in 2-by-2 tables.

$$4. DI = \sum_{i=1}^{i=n} \left(\frac{A_i}{\sum_{i=1}^n A_i} \right)^2$$

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