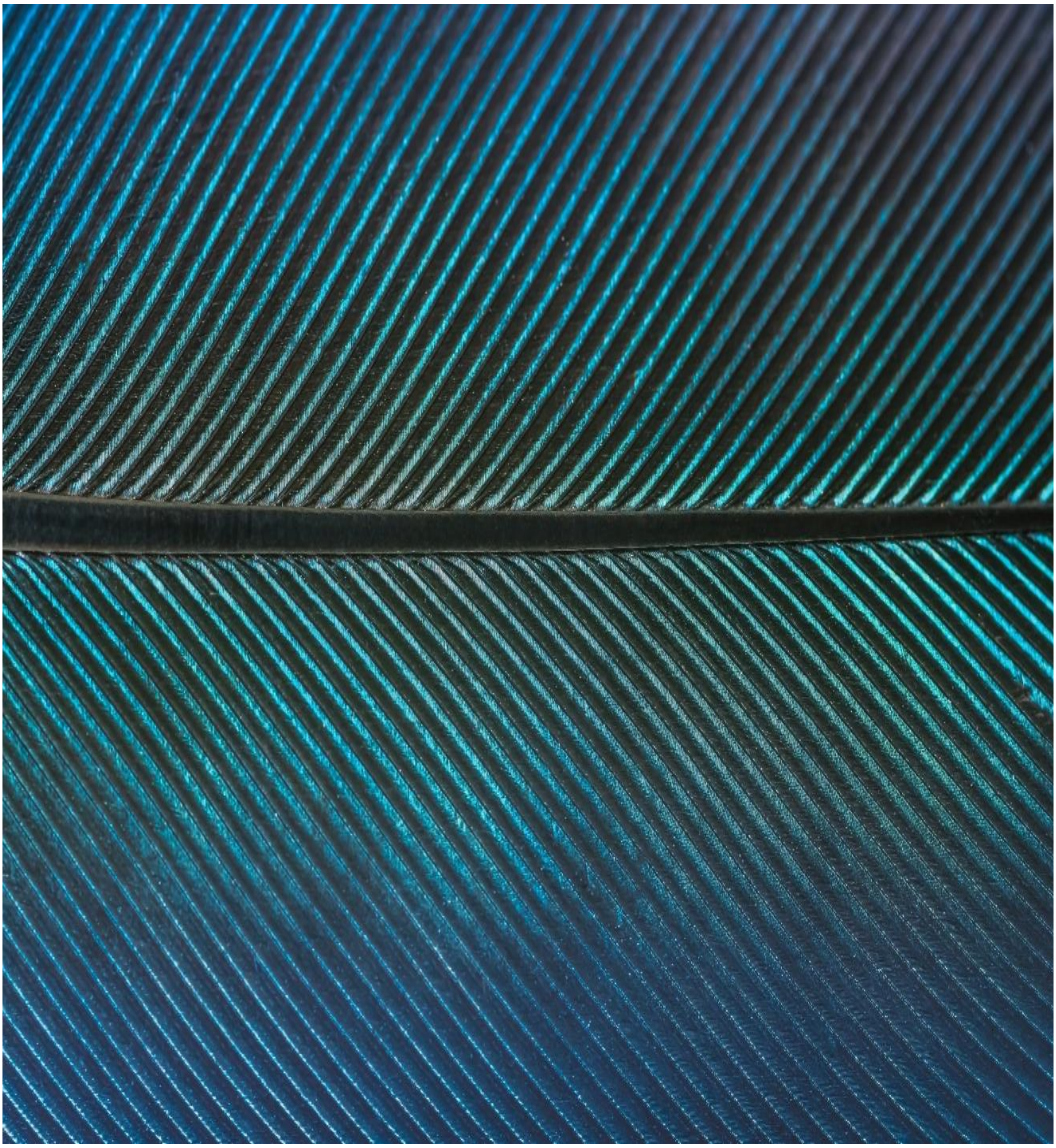
Thinking Ahead Institute

Total portfolio approach symposium summary

11 March 2020, Sydney

Draft



Objectives of the Symposium

- Learn from expert practitioners and technicians about Total Portfolio Approach (TPA)
- Explore what can be done in practice
- Develop some practical, actionable takeaways and some ideas for further research

Attendance at the Symposium

- Over 30 senior investment professionals with an interest in developing their knowledge of total portfolio thinking. Our panel was made up of four TPA experts
- We reached out to four segments, but mostly concentrated on the Institutional/Asset Owner group

	Institutional	**Retail**	**Wealth**	**Hedge funds**
Situations	Asset Owners – particularly pensions, SWFs	Multi-asset mandates – particularly balanced funds	Personal portfolios	Macro (multi-asset) funds
Prevalence	Very small	Very small	Growing	Significant

Framework for considering TPA

- We think that TPA is a superior approach to portfolio construction relative to traditional alternative methods, notably SAA

- TPA addresses and can overcome three issues with SAA practice – issue with alignment with investors' goals; managing and optimising within sectors to a tracking error; framing problems within an asset class set-up. In particular SAA generally underweights or excludes "stuff that doesn't fit anywhere" eg reinsurance assets

- On a like-for-like, WTW believes using TPA is likely to be worth 0.5 to 1% in better annual returns than traditional SAA methods. On a poll taken at the conclusion of the meeting participants median view agreed with this figure with a mean figure of a 0.6% per annum advantage (see page 7 for this polling with further polling on pages 8 to 12)

The story so far:

- The SAA approach in the 1990s and 2000s
  SAA was a perfect construct for a time when Boards were dominant, issues were less complex and managing the managers was the major issue.

- Governance was always critical
  Boards were comfortable with their policy role (Beta), managers were comfortable with an implementation role (Alpha). SAA worked

- Roll forward in time to the 2010s
  As internal teams grew and portfolio considerations become more complex, certain funds saw merit in splitting roles differently. TPA was born

- Evolved TPA practice recently
  The adoption of TPA by other funds has been in a range of areas, but always aligned to goals-centred, joined-up dynamic management

- TPA adoption and growth
  This TPA innovation has been slow to catch on. We explore possible reasons.

Panel contributions (1)

Nigel Wilkin-Smith (Future Fund – 'FF')

- When FF was founded in 2006, David Neal recognised the problem areas with SAA including cultural alignment with and commitment to objectives and benchmarks
- This led to the adoption of a TPA framework in which Board beliefs were curated and interpreted by the Executive to shape each investment mandate that they receive
- The use of outside managers results in high costs but FF manages to a net of cost return, and use scale to their advantage
- FF are currently (and constantly) testing liquidity, risk management and governance to be able to use their risk budget fully. They don't use a dynamic reference portfolio
- The culture is distinct, highly focused on one team for one portfolio and inextricably linked with their investment process
- DAA and illiquidity areas have added a similar amount to returns through time, enabled by the TPA method
- Data and technology platform has taken three years of strategic planning to get to the fit for purpose/minimum viable position

Dynamism

- FF have three levels of dynamism:
  - equity equivalent exposure (equity beta); they have a neutral level of 0.55
  - equity beta mix
  - basket of management within that
- FF philosophically disagrees with reference portfolios, but this means sizing positions is difficult
- In normal conditions the threshold for tilting is high; FF are building out a systematic platform for this, but currently using model portfolios and going to IC which meets twice a month and more frequently as needed
- A comparative advantage is that they can provide capital in times of market stress; they don't need to be a forced seller
- They are not trying to time markets – their time horizons remain long-term and they want to be able to gradually add risk as the market becomes more attractive

Governance

- Board influence is significant through engagement and oversight but the Executive has reasonably substantial delegated authority
- The Exec doesn't have much delegation from Board of Guardians on manager and asset selection. However there is more delegation around EEE (+/- 7.5%) which is going to have the most impact
- All remuneration and individual objectives are linked to CPI plus targets

Risk management

- FF uses a three year CVar currently; possibly a 10 year CVar is actually more aligned with objectives and mission
- Short term liquidity management – not expecting inflows or drawdowns, but are focused on ensuring they can meet the liabilities and obligations especially in offshore investments
- Portfolio flexibility – want to be able to survive shocks, don't want to have to sell low or be a forced seller; and also want to be able to take advantage of opportunities
- Peer risk is not a structural issue, only that if they underperformed the large funds in Australia then questions would be asked.
- On sustainability FF have created a new function to focus on strategic opportunities & integration in sustainability. Portfolio integration role is about making the right decisions on the right basis.
- Current focus is 'pre-mortem' on coronavirus and how to grapple with absolute return objectives

Panel Contributions (2)

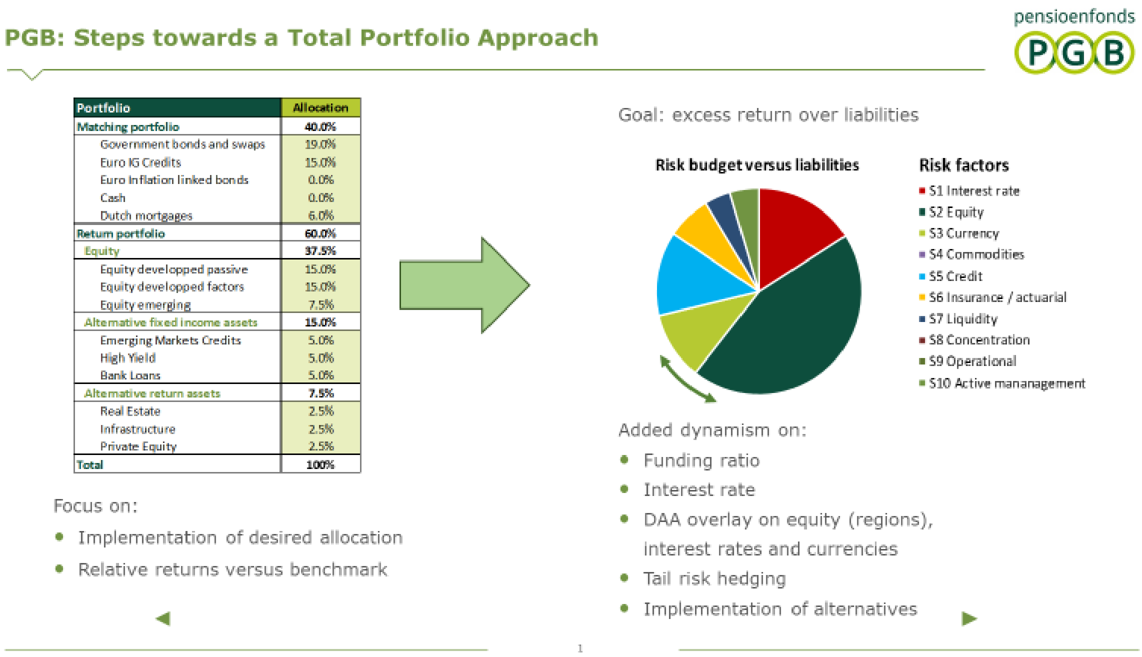
PGB – Jeroen Rijk

- PGB Board has ultimate accountability because of legislation
- They don't call what they do 'TPA' but draw on many of these techniques and so are on the spectrum tilted away from SAA towards TPA
- Reason for this approach was that during the financial crisis of 2008, when the Board queried whether they could have foreseen the risk of the crisis ahead of time and made timely calls
- PGB has most of its assets managing DB liabilities. PGB's goal is to meet pension liabilities, so this formed part of their objective. They then applied other lenses – moving to a risk factor and risk budget framework. Finally, they added dynamism which allowed them to use risk budget when they felt they would be rewarded; this included a DAA overlay in equities, and also a dynamic tail hedge when they deem risks are high
- They had found that the SAA approach led to nuances such as the most credit risk they had was in their government bond portfolio, because they were trying to maximise the returns in that part of the portfolio
- Transitioned from more traditional policy allocations to risk positions between 2017 and 2018:

Matching portfolio	46.0%
Government bonds and swaps	22.0%
Euro IG Credits	13.0%
Euro Inflation linked bonds	5.5%
Cash	0.5%
Dutch mortgages	5.0%

Riskbudget matching	4.8%
S1 Interest rate	3.5%
S5 Credit	1.3%
Euro IG Credits	0.7%
Dutch mortgages	0.6%

- Their regulator understands what they are doing and are happy with that. One challenge they face from a regulatory perspective is that the more risk they take the more funding they need
- Dynamism is not a strong belief
- Peer group is not an issue – but they do get asked by some stakeholders
- They are moving to DC pension system which is likely to take the form of life cycle in accumulation, then moving to a DB looking configuration for the first decade of retirement phase
- The following schematic outlines the PGB total portfolio thinking



Panel Contributions (3) – the Soft Strands

TCorp – Stewart Brentnall

- Three axioms at TCorp – customer mission should come first; respect the political agenda and what do they use their capital for (infrastructure, schools, roads); stakeholders don't need to know all the technical investment detail
- Boards in general only meet four times a year, with only 30-45 mins each, so high level grasp only
- Importance of culture. The Jim Collins classic 'Good to Great' suggested getting right people on the bus came before you even know where the bus is going. Then get delegations right through building of trust. Then fix the remuneration of individuals with a blend of the what (whether they meet objectives) and how those objectives are met
- Organisational structure should meet portfolio structure:
  - the investment advisory team picks up client needs (how much risk, what complexion of risk)
  - portfolio construction turns these needs into an investment with partner selection function to work to manage partner lifecycle
  - have a stewardship team to bring consistency of ESG integration
- The soft stuff is vital, a few illustrations here
  - *Change management* is a tough ask supporting the attitudes to change but on top of BaU
  - *Incentives.* TCorp has chosen to align/remunerate on overall fund objectives
  - *Measuring culture* has been an important exercise for them; highlighted a need for clarity of purpose and transparency across the team
  - *Accountability*. Their people need to have clear line of sight to the underlying business need that each of their 16 portfolios is intended to meet
  - *Transparency.* TCorp has numerous forums, single physical working space
  - *Diversity.* Gender diversity quite good overall with leadership team is 50/50, investment team is around 30%; cognitive diversity being studied

Australian Super – Justin Pascoe

- Passionate about a one fund philosophy concept. The annual conference showcases a commitment to this by getting everyone in the room to talk to their purpose and vision
- The extraordinary growth of the Fund has meant that they have had to build out capabilities quickly and transitioning to a predominantly in-house capability has been a huge ask
- TPA was an underlying thinking emphasis that was more prevalent in the early days when the team was smaller and more connected. There are more specialists in the team now and TPA is prevalent within each of the three buckets (equities, fixed income and cash). Portfolio construction and asset allocation groups round out the five groups that report into CIO.
- Implementations are done within asset classes and sub-cultures inevitably develop at that level. Implementing a TPA when you are peer aware takes agility – asset allocation and costs are a clear constraint, and then optimise as best they can within that construct
- Asset allocation, indeed any decisions to deploy capital into certain asset classes, is determined by those five heads that make up an internal IC. Australian Super has also a traditional Board and IC structure setting high level strategy and providing oversight
- The soft stuff is vital, illustrations:
  - *Multi-location*. The addition of overseas offices has been natural to build out capabilities but carries issues around control and co-ordination; and culture too
  - *Talent*. Building the talent and cohesion of the organisation is critical. They have the ability to grow their own talent through a graduate program and rotate them all over the organisation, learn different parts of the portfolio, potentially move to other offices around the world – all part of a growing EVP to help stretch the team
  - *Incentives*. There is a natural internal tension that they want to be able to attribute/measure whether they are adding value (especially internal management) and so the TPA mantra is harder to work with

Other discussion points on the soft strands

- *The HR function*. What is the strategic role of HR. Participants agreed there are some significant gaps, but it should complement rather than replace the role of leadership in setting the tone of culture. See page 9 for polling results
- The organisations most progressed on TPA across the world quite a large number are in the Australian region, and have largely had the luxury of starting from a blank sheet of paper, sit in a single location and often on the same floor
- *Organisational design* examples:
  - CPPIB, New Zealand Super and Future Fund – the three trail-blazers for TPA all have evolved different structural designs
  - In CPPIB for example there is a TPA team of about 100 people specialising the TPA craft.
  - FF portfolio strategy team is experimenting with an analyst pool structure. They will all need to develop a suite of skills including quant and coding as well as qualitative
  - NZ Super has been very joined-up from day one and still benefits from smaller structure and one account only
- *Cultural aspects*
  - Multi-site organisations have a design that tends to impede one-team one-culture, with sub-cultural dimensions
  - Younger generation of professionals are particularly concerned about feeling engaged, empowered, included
  - Importance of psychological safe space and an environment where failing can be 'cushioned'
  - Organisations may be rallying around one-purpose instead of one-team, this may be a better development plan

Some 'hanging' questions – with TAI research needed

- How can AOs design their decision rights and responsibilities optimally? (See design feature polling on page 8)
- Is the strong status quo bias of boards something that can be addressed? This is a fundamental question of governance and accountability
  IC best-practice research from TAI is forthcoming on both these areas
- How do asset managers lean into the needs of AOs? Can we foresee a future where AOs write a cheque for the research, and execution done by the manager?
  Research on industry landscape is a continuing TAI activity
- Dynamic allocation. Where should funds find that sweet-spot? How much nimbleness works best?
  We will raise this through the TPA Working Group. There is considerable individual context
- Can sustainability be done better with TPA? Not obvious that it would be done differently if sustainability remains substantially a policy level decision.
  TAI is preparing research on this and this will be considered at the TPA Working Group
- What qualities of leadership are needed for TPA success? Given that leadership can be exhibited at all layers of the organisation (leadership widely defined is wherever someone steps out of their immediate tasks to help others), what qualities of leadership do you need to show throughout the organisation related to one-team culture?
  These questions will be considered as part of the Power of Culture Study that we are conducting currently

Total portfolio approach symposium summary

Actions and takeaways (WISDOM = What I Should Do On Monday)

- *Culture*. If you start with One Purpose, it is easier to get to 'One Culture' and 'One Team'
- *Educating boards*. The benefits of TPA and a more agile governance framework are not fully intuitive, it will require a big education and socialising effort
- *Journey for boards*. Best to take them on small steps to make the journey feasible. TPA is complicated and there is no one way of doing it
- *Siloes*. Break down siloes through composition of project teams – collaboration, cross discipline, not respecting seniority. The importance of a common language to break down silos
- *Nimbleness*. Discussion is needed with Board on what portfolio flexibility is right, how much do you want/need to be able to do what you want to do; how do you access this, is it delegations, is it team structure/organisation. What does success look like?
- *Change*. Change sometimes happens around us, but you need to have the right people who are able to deal with change (not just recognise it but also manage through change) and have the mindset and ability to change

In conclusion

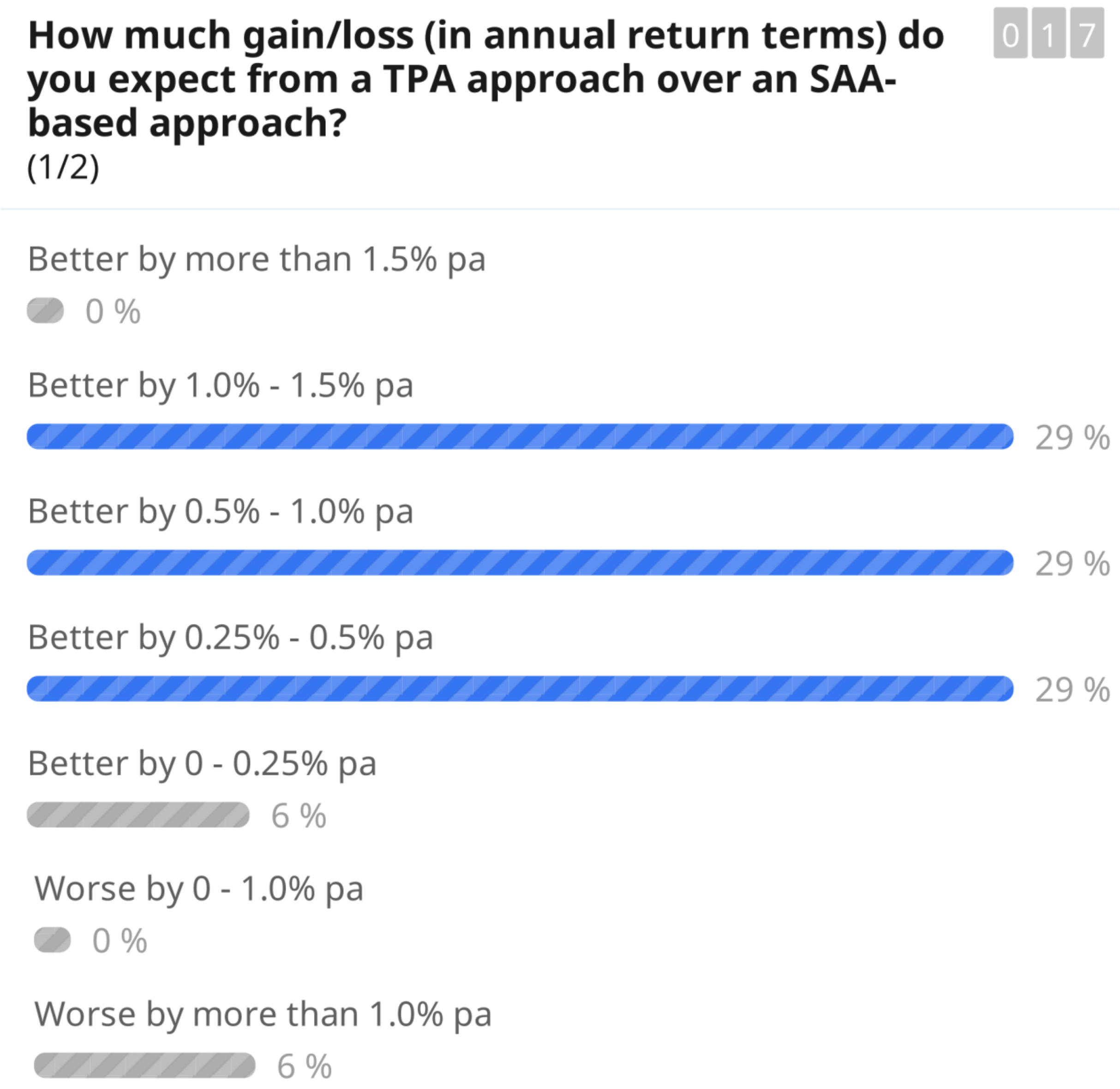
- We believe we have broken new ground in convening the first such detailed meeting *anywhere* that was focused on TPA
- The meeting was extremely successful. We are very appreciative to our four panellists and to the other participants for their high level of engagement

Roger Urwin
Jess Melville
2 April 2020

Participant polling results

1. Gains/losses from TPA vs SAA
2. Positive design features
3. Gaps in design features
4. Positive culture features
5. Gaps in culture features

1



2

Which organisational design features do you believe are important to TPA success? List up to three

(1/2)

0 1 9

Develop the decision rights and responsibilities matrix, documentation and application

68 %

Develop greater focus on personal and team goals and accountabilities

32 %

Create flatter organisational structure with greater transparency

32 %

Reduce or remove the asset class team dominance in the organisational demand

47 %

Introduce network team structure alongside hierarchical team structure

42 %

Strengthen the strategic contribution of the HR function

16 %

Design variable compensation to include contribution from total return versus goals

47 %

3

Which organisational design feature is your organisation's biggest single 'gap'?
(1/2)

019

Develop the decision rights and responsibilities matrix, documentation and application

16 %

Develop greater focus on personal and team goals and accountabilities

21 %

Create flatter organisational structure with greater transparency

0 %

Reduce or remove asset class structure dependence on org design

5 %

Introduce network team structure alongside hierarchical team structure

16 %

Strengthen the strategic contribution of the HR function

32 %

Design variable compensation to include contribution from total return versus goals

11 %

4

Which organisational cultural features do you believe are important to TPA success? List up to three
(1/2)

020

- Culture exemplified by leadership behaviours and tone at the top — 60 %
- Culture reinforced in performance check-ins and reviews at all levels in the organisation — 5 %
- Development of a one-team culture - focused on team contributions and collaborative behaviours — 75 %
- Development of an innovative culture - focused on creativity, connectivity and ownership — 40 %
- Development of a transparent culture - focused on openness, feedback and personal growth — 30 %
- Development of a resilient culture - focused on long-term staying power, adaptiveness and integrated thinking — 30 %
- Development of an inclusive culture - focused on respect and fairness and cognitive diversity — 45 %

5

Which organisational cultural feature is your organisation's biggest single 'gap'?
(1/2)

0 1 9

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Mobilising capital for a sustainable future.

Since establishment in 2015, over [60] investment organisations have collaborated to bring this vision to light through designing fit-for-purpose investment strategies; better organisational effectiveness and strengthened stakeholder legitimacy.

Led by Tim Hodgson, Roger Urwin and Marisa Hall, our global not-for-profit research and innovation hub connects our members from around the investment world to harnesses the power of collective thought leadership and bring these ideas to life. Our members influence the research agenda and participate in working groups and events and have access to proprietary tools and a unique research library. They have also helped form our **top ten** investment beliefs.

1. Economies and markets are **complex adaptive systems**, requiring different thinking
2. **Sustainable value creation** starts with **purpose**. It can, and should, be measured and communicated. Integrated Reporting is a transparent and effective method
3. A new interpretation of sustainability is needed to advance a **better social purpose** in the investment industry
4. **Long-horizon investors** have a significant advantage because there is a quantifiable premium
5. **Climate change** will significantly affect investments
6. The **asset classes of tomorrow** will be substantially different
7. The returns you need will only come from **a system that works**
8. Pensions are worth more in a world worth spending them in
9. **Culture** is a unique ingredient in gaining a **competitive advantage** and effecting change
10. **Collective decision-making** is a skill that can be developed

Join the Thinking Ahead Institute

We seek collaboration with like-minded organisations to achieve our vision, so for more information about us please contact:

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