Thinking Ahead Institute

It's about time

Total portfolio thinking and practice

It's about time

Total portfolio thinking and practice

Contents

Executive summary ... 2

Chapter 1: Introduction: definitions and concepts ... 4

Chapter 2: The relative advantages of SAA and TPA ... 10

Chapter 3: The tough questions on TPA ... 13

Chapter 4: A roadmap for transitioning to TPA ... 17

Chapter 5: Conclusions ... 18

Appendix I: A total portfolio best-practice checklist ... 20

Appendix II: A portfolio quality dashboard illustration ... 21

Limitations of reliance ... 22

About the Thinking Ahead Institute ... 23

Executive summary

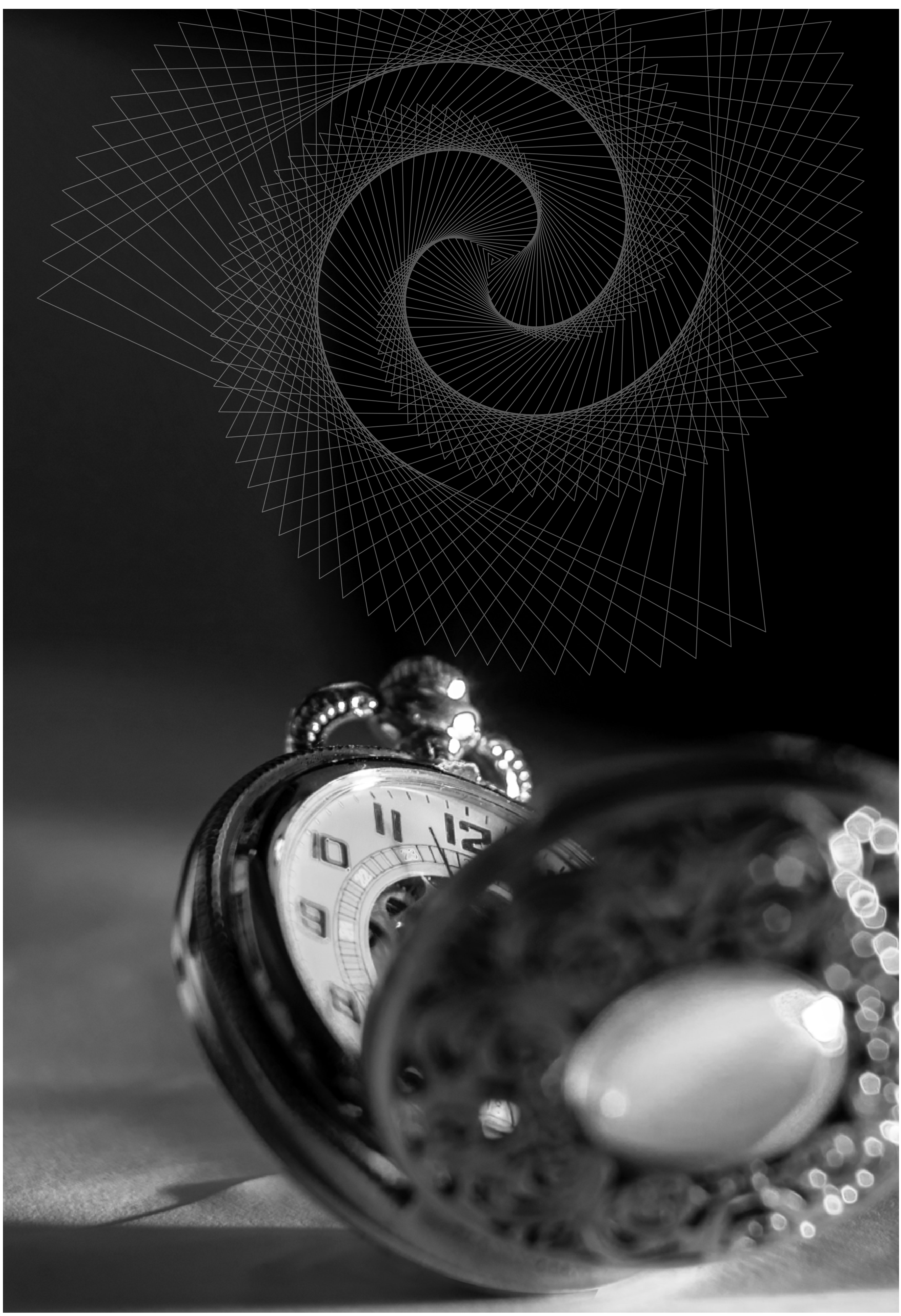
Key points

Key points

- The established practices of strategic asset allocation (SAA) have been shown to be inefficient in delivering the highest risk-adjusted returns and the best long-term outcomes
- Alternative portfolio management practices centred on total portfolio thinking and methodology – in which each asset contributes positively to total portfolio efficiency and quality in a competition for capital – have been successfully implemented and evolved by a small number of asset owners (AOs). We refer to these practices as the total portfolio approach (TPA). In some parts of the industry total fund management (TFM) is the preferred term, the concepts are essentially the same
- One of the main merits of this approach is that it allows the executive to make better use of time and be nimbler over time. This key attribute can't be emphasised enough, hence our title: *It's about time*
- While each AO has a unique context, we see four principles supporting best practices: deepen total portfolio methodology, create total portfolio dashboards, build and re-set internal spending and align a one-team culture
- We suggest AOs making the switch from SAA to TPA will need to undertake transformational change, via a roadmap, that involves a number of parallel project streams covering governance, cultural and technical aspects
- We recognise that some AOs use SAA arrangements effectively and may prefer to adopt smaller change via applying total portfolio thinking to their SAA arrangements
- There are significant applications of TPA for asset managers (AMs) and they can contribute significant thinking to the advancement of TPA and its take-up by AOs.

Research resources

- Total Portfolio Approach (TPA) – A paper about a global AO study into current and future asset allocation practices, which includes discussions on the findings of a 'peer study' of 18 large AOs worldwide and describes the research investigations that were generated
- A Thinking Ahead Institute (TAI) symposium on TPA took place in Sydney, in March 2020, to explore the hard strands (technical) and soft strands (governance, talent and culture) involved in a TPA and identified six unanswered questions raised in the above paper
- A Total Portfolio Approach white paper, authored by Roger Urwin and Tim Unger in August 2020 gives a combined technical and practical guide, and contrasts it to SAA. This research is available on request
- A TAI Working Group on TPA operated between July 2019 and March 2020 and this paper incorporates the work of this group and we are indebted to these members for their advice:
  - **Stewart Brentnall** (TCorp)
  - **Damian Graham** (First State Super – now Aware Super)
  - **Chris Mansi** (Willis Towers Watson)
  - **Jeroen Rijk** (PGB Pensioendiensten)
  - **Sonia Sawtell-Rickson** (HESTA)
  - **Eric Tazé-Bernard** (Amundi Asset Management)
  - **Tim Unger** (Willis Towers Watson)
- The *Investment Organisation of Tomorrow* TAI Working Group is operating from March 2021 and is considering total portfolio approaches as part of its scope.



Chapter 1: Introduction: definitions and concepts

Key concepts

AOs have tended to adopt relatively static approaches to asset allocation and portfolio construction, based around an SAA or 'policy portfolio'. While there are various reasons for this practice, we argue that investment efficiency is not one.

The investment drawbacks of SAA are principally due to there being a looser connection between the resulting portfolio and the fund's goals and how these change over time, combined with a slower and more constrained decision-making process.

In this paper, we argue for a switch of thinking to better connect the total portfolio with the fund goals. Such thinking leads to an alternative approach to portfolio construction, in which the central theme is to construct the portfolio of assets such that there is a continuous and dynamic focus on achieving the explicit objectives of the AO. Such thinking has been embedded in alternative methodologies which are referred to collectively as total portfolio approaches.

We refer in this paper to the AO challenge, but include many issues of key relevance to AMs. First, AMs must design their portfolio construction by understanding the client mandate and interpreting the key differences between SAA and TPA arrangements. Secondly, while most mandates are specialised and limit the asset classes to be used, in some cases AMs manage multi-asset mandates in which either SAA or TPA arrangements can be applied. The multi-asset mandates where TPA may have merit include diversified growth funds, absolute return funds, target date funds in defined contribution mandates and OCIO mandates (outsourced CIO).

Strategic asset allocation

- The SAA approach involves separating the investment process into two parts: a strategic part with the creation of a *Policy Portfolio* (see table 1); and an implementation part with the delegation to multiple managers of portfolios. This reflects governance arrangements where high-level *'Board'* (or investment committee) processes determine the policy portfolio and, where possible, this is supported and augmented by the *'Executive'* (team) which is then implemented through various mandates. The potential problems with this approach can be summarised as follows:

- SAA is seen as the primary mechanism for achieving a fund's investment goals, but because it is updated infrequently – often according to calendar-based meeting schedules – in practice it has a looser connection to these goals

- Decision rights for the SAA often reside with the Board at the highest level, with lower-level-allocation decisions delegated to the CIO / Executive team. As a result, decision-making processes are separated, slower and less agile and may be disjointed and less *joined-up*

- The primary components of the SAA approach are asset class *buckets*, which are required to be filled, leaving less room for deviation from their agreed weights and less room for certain assets not included within asset classes.

"In this paper, we argue for a switch of thinking to better connect the total portfolio with the fund goals. Such thinking leads to an alternative approach to portfolio construction, in which the central theme is to construct the portfolio of assets such that there is a continuous and dynamic focus on achieving the explicit objectives of the AO."

Total portfolio approach

The TPA approach is orientated around an initial decision reached by the Board on risk usually through a *Reference Portfolio* (see Table 1) to guide the Executive on the amount of risk suitable to meet the fund's objectives. This is generally characterised by:

- A continuous focus on achieving the fund's investment goals
- A decision-making process that is *joined-up* with significant use of delegated decision-making, while portfolio-level decision rights reside with the CIO / Executive team and the risk budget and risk appetite resides with the Board
- The portfolio being managed dynamically in real-time with all investment opportunities competing for capital, but only the best ideas getting into the portfolio.

Table 1 – **Policy Portfolio and Reference Portfolio**

Term	Description
Policy Portfolio	▪ A multi-asset class portfolio which meets the fund's objectives and which can be implemented via allocations to manager mandates. ▪ The Policy Portfolio would usually be much more complex than a Reference Portfolio. ▪ **Example:** The Yale endowment policy portfolio has allocations to 7 distinct asset classes.
Reference Portfolio	▪ A simple, low cost, passive portfolio, made up of allocations to a few asset classes represented by broad market-capitalisation weighted indices. A Reference Portfolio can be considered to be the simplest portfolio which reflects the chosen risk profile and is likely to be close to achieving the fund's objectives. ▪ While a Reference Portfolio can be constructed to meet some of the fund's objectives, a more diversified and therefore more complex portfolio (incorporating the use of other risk premia, such as private markets and the use of active management) may be needed to have greater confidence in meeting all of the fund's objectives. ▪ **Example:** The CPPIB Reference Portfolio is made up of 85% global equities (currency hedged) and 15% Canadian government bonds.

In summary, the TPA investment effort is a one-step *integrated approach* with the Executive, supported by the Board, working on one shared objective. Whereas in SAA, it is a two-step *separated approach* involving the Board, with Executive support, first deciding the top-down SAA then the Executive working on their respective portfolio mandates. These details are captured in Table 2.

What a TPA investment arrangement actually looks like for an AO or an AM should reflect their beliefs, organisational structure and culture. Ultimately, what is of greater importance is that each line item in the portfolio is there for a good reason, is amongst the best investment opportunities available to the fund at that point in time and makes a meaningful contribution to the overall portfolio outcomes.

The concept of TPA is both a behavioural construct (i.e. relating to mind-set) and a technical construct (i.e. relating to process and governance). When fully present in mind-set, process and governance, a TPA is well-equipped to deliver outcomes that are consistent with the fund's mission and goals, with likelihoods of success significantly higher than are possible through using customary SAA-based approaches. We estimate that for a TPA process that is done well, these advantages (in return terms) could be worth in the region of 50-100 basis points in total[1] (0.5%-1.0%) per annum. We believe that a TPA should produce a portfolio that fares better on risk measures and advanced sustainability practices as well.

Strategic Asset Allocation (SAA)

Boards
decide top-down SAA

External managers
implements the SAA through portfolio mandates

Oversight
oversees the mandates managed by managers

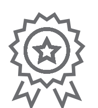
Success
judges results in terms of alpha from mandates

Total Portfolio Approach (TPA)

Boards
decide risk profile through Reference Portfolio

Internal teams or OCIO
implements the TPA through a competition for capital

Oversight
oversees the total fund outcomes



Success
judges results in terms of value added over Reference Portfolio

[1] It is worth noting that in a group of 40 state-owned investors (source: Global SWF May 2021 Newsletter) – including SWFs and public pension funds – five organisations that employ total portfolio thinking and methodology (New Zealand Super, Future Fund, CPP, CDPQ and OTPP) are in the top six of the whole sample by five year performance. They all performed above 8.0% per annum from 2015 to 2020, while median performance for the group was 6.0% pa.

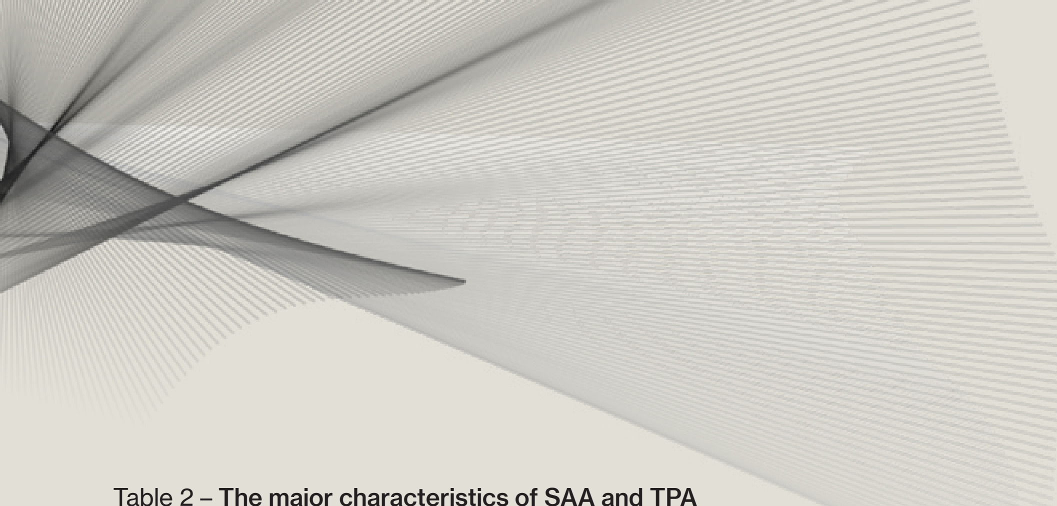


Table 2 – **The major characteristics of SAA and TPA**

Characteristic	Strategic Asset Allocation (SAA)	Total Portfolio Approach (TPA)
Policy	▪ Asset classes define the normal investment opportunities. Opportunities that lie outside these asset classes are often not considered for inclusion ▪ Asset classes are the primary building blocks and focus. Capital allocations get more focus than risk allocations ▪ Calendar-based updates to the SAA, often agreed by the Board. The allocations are not finely calibrated to current market valuations and circumstances ▪ Policy and implementation are separate	▪ All assets pre-qualify for consideration on equal terms on their merits. Good opportunities often don't fit into existing asset class labels ▪ Whilst allocations are still made to asset classes and mandates, risk allocations get prominence ▪ Implemented in real-time by the Executive team and calibrated to current valuations and market circumstances ▪ The policy and implementation are one process
Implementation	▪ Implemented by asset class teams or external managers ▪ Often leads to teams that function separately and which are not well aligned with the overall fund mission and goals ▪ The implementing manager is in the narrower role of adding alpha	▪ Implementation coordinated by a single team working collaboratively employing internal or external mandates / teams ▪ Leads to an organisation that is working as 'one team' and which is well aligned to overall mission and goals ▪ The implementing manager is in the role of adding risk-adjusted return
Measuring performance and success	▪ The focus is on outperforming the policy portfolio / SAA benchmark ▪ Narrower measures of performance tend to be the focus with success often considered as the extent of value-added over the SAA	▪ The focus is on achieving the fund's overall mission and goals ▪ Success is assessed through a focus on total fund return relative to liabilities where appropriate and with contribution to wider stakeholder goals considered too

Figure 1 – **The spectrum of portfolio construction approaches**

	SAA	TPA
Performance assessed vs.	Benchmarks	Fund goals
Success measured by:	Relative value added	Total fund return
Opportunities for investment defined by:	Asset classes	Contribution to total portfolio outcome
Diversification principally via:	Asset classes	Risk factors
Asset allocation determined by a:	Board-centric process	CIO-centric process
Frequency of change:	Infrequent, calendar meeting based	Continuously monitored, changes made in real time
Portfolio implemented by:	Multiple teams competing for capital	One team collaborating together

Better decision framing (Performance assessed vs.; Success measured by; Opportunities for investment defined by)

Better decision making (Opportunities for investment defined by; Diversification principally via; Asset allocation determined by a)

Greater dynamism (Asset allocation determined by a; Frequency of change; Portfolio implemented by)

SAA and TPA as a spectrum issue

In practice, whilst there is a spectrum of portfolio construction approaches; we think it is helpful to think of traditional SAA-based approaches sitting at one end of a spectrum and a "fully fledged" version of TPA sitting at the other end. Because there are several components to the portfolio construction process, a TPA can really be thought of as reflecting *greater levels of conviction* (in moving from the left-hand side to the right-hand side on these different components, as illustrated in Figures 1 and 2).

Figure 2 – **Strategic Asset Allocation, Total Portfolio Thinking and Total Portfolio Approach: unpacked in detail**

	Strategic Asset Allocation	Total Portfolio Thinking	Total Portfolio Approach
Strategy	SAA derived from an ALM or other exercise	Total portfolio return target and risk profile as expressed via a reference portfolio	Total portfolio return target, risk profile and a range of other "budgets" (e.g. sustainability, complexity)
Measure of success	Outperformance vs the SAA benchmark using marrow measures of performance	Value added by total portfolio against a reference portfolio through use of a balanced scorecard	Total fund risk-adjusted return and contribution to wider stakeholder goals (e.g. sustainability / impact) through use of a balanced scorecard
Opportunity set	Opportunity set defined by asset classes, opportunities outside predefined "buckets" often not considered for inclusion	Opportunity set divided into more broadly defined asset class "buckets" (e.g. based on return drivers) enable greater opportunity capture	All assets pre-qualify for consideration on equal terms and are considered on their merits
Building blocks	Asset classes are the primary building blocks; focus on capital allocations	Allocations made to broader "asset classes" with risk and capital allocation considered side by side	All investment opportunities compete against each other for an allocation of the risk budget; contribution to total portfolio risk factor exposures gain prominence
Decision making	Optimise vs benchmark within each asset class bucket, typically constrained by tracking error limits	Portfolio quality scorecard used to compare different potential portfolios through multiple dimensions; strategic portfolio may exist but is not a constraint	Multiple lenses into risk and return drive allocation decisions; contribution from different "levers" for value add aligned to beliefs and comparative advantage
Frequency of change	Calendar-based updates to the SAA, often agreed by the Board; generally not calibrated to current conditions	Real-time decisions made by a mix of the Executive team and the Board based on materiality (e.g. within vs between asset classes), reflecting current conditions	Real-time decisions made by the Executive team to build the best portfolio to achieve objectives based on market conditions at a point in time
Implementation	Implemented by asset class teams or external managers, leading to "siloed" teams that which are not well aligned with the overall goals; tends to use the implementing manager in narrow role of adding alpha	Portfolio strategy function sits alongside asset class teams to ensure alignment of bottom up decisions with overall fund mission and goals; some use of implementing managers is broader roles	Implemented by a single team working collaboratively, leading to 'one team' and which is well aligned to overall fund mission and goals; implementing managers used in the broader value-adding roles

Chapter 2: The relative advantage of SAA and TPA

In Chapter 1 we discussed some of the merits of the respective approaches. In this Chapter we go deeper into advantages and disadvantages, considering both technical and soft considerations

Several technical advantages to TPA

TPA offers better framing of the key decisions through alignment with the fund's top objectives

Under a TPA, there is a greater focus on achieving the fund's mission and goals rather than, for example, outperforming benchmarks or peers. A portfolio construction process which is *freed up* to focus mainly on achieving the fund's specific objectives does not suffer as much from inertia and a *governance drag* that results from being too anchored to a SAA benchmark or peer group or suffering the constraints of tracking error. In SAA arrangements, there are more subordinate goals to which incentives are attached that are only proxies for the overall goals.

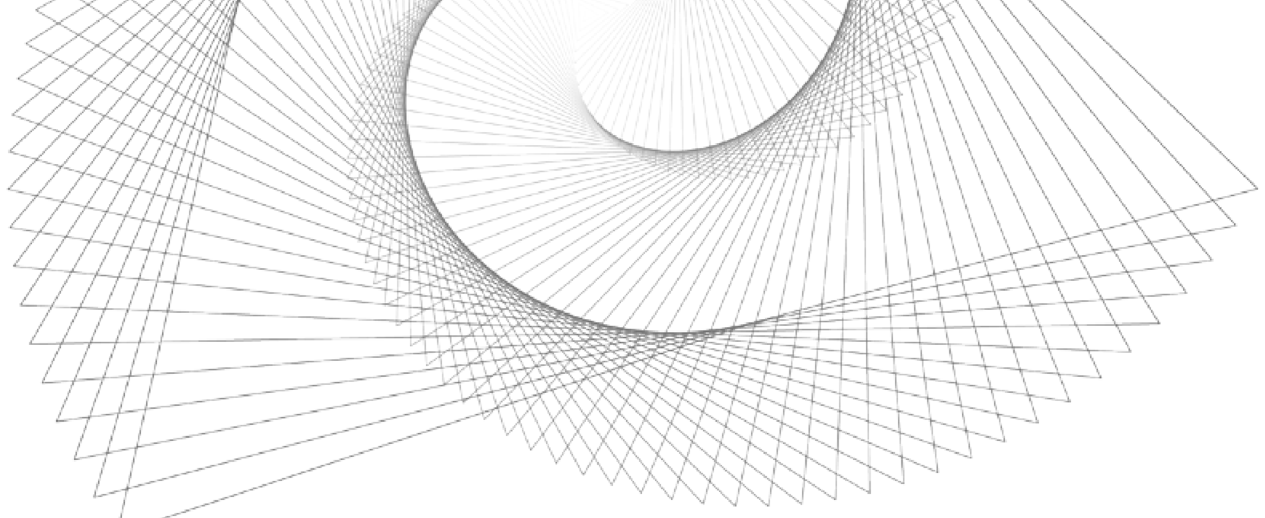
A connected point relates to those funds with defined liabilities like DB pension funds. SAA policies may be fixed by reference to liabilities and funding status, usually by use of asset liability modelling studies. But in these arrangements, there is no explicit ongoing integration by which added value on top of the SAA is linked to improvements in funding status. By contrast TPA arrangements will seek to make returns relative to liabilities the principal measure of progress and therefore incorporate explicit integration of the assets with the liabilities. This allows TPA arrangements to optimise the liability hedging in ways that SAA arrangements cannot match[2].

TPA supports better quality of decision making around best ideas, absolute returns and risk factors

Using a TPA, decision rights reside with the teams or individuals who are best suited to make those decisions, with the Executive team often managing the specific allocations to risk factors (exposures), asset classes and mandates. We believe that a TPA more generally leads to a portfolio consisting of the *best ideas*, with fewer biases towards particular asset classes or strategies. In addition,

> *"Under a TPA, there is a greater focus on achieving the fund's mission and goals rather than, for example, outperforming benchmarks or peers."*

[2] See *Beath et al* | *The Canadian Pension Fund Model* |2020 | which shows the empirical link between the degree of hedging liabilities of funds and their performances, both in risk and return terms.



because the investment opportunities considered in a TPA are not limited to only those opportunities that fit within pre-specified asset class buckets (all investment opportunities effectively pre-quality for inclusion), there is a wider opportunity set to choose from. If an AO has the skill set to identify the most attractive opportunities, then a wider opportunity set should also result in a higher quality portfolio. Furthermore, many of the best new investment opportunities do not fit neatly into existing asset class definitions. And it is worth noting that under a TPA, the implementing manager has more scope to add value in absolute terms, by contrast the implementing manager is more restricted to alpha when operating a SAA. Some might argue that a Reference Portfolio acts as a tracking error constraint, but it clearly has a lesser influence than an SAA.

This greater focus on allocating to risk exposures associated with TPA – rather than on asset classes – results in a higher-quality portfolio, principally by making greater use of diversity principles to build a portfolio that is more robust to an uncertain future. This is akin to making greater use of the principles that underpin risk-parity portfolios, i.e. aiming to construct a more *balanced* investment portfolio rather than one dominated by a small number of risk factors or return drivers.

TPA offers greater dynamism in the decision-making process through timeliness and nimbleness

A TPA allows a fund to be more dynamic and reflect its specific circumstances, investment conditions and / or market opportunities. By contrast, a SAA approach is much more tied to a calendar-based meeting schedule, often based on decisions made by a Board-led process that is not as finely calibrated to market valuations or circumstances. In other words, a TPA enables funds to make more timely decisions.

A connected point is that it better equips funds to deal with the time-varying nature of risk premia by letting the risk budget be flexible to changing market opportunities. So, in addition to nimbleness, a TPA allows more flexibility when allocating the risk budget in order to optimise money-weighted opportunities.

TPA does better with universal ownership and at integrating sustainability practices

A TPA is better able to integrate the investment impacts of (and on) environmental, social and governance factors. This is because it deals with policy and implementation at the same time. In particular, a TPA can make use of the implementing manager to add value from traditional and sustainability factors (not confined to 'alpha') and thus enable the integration of all sustainability factors at both a top-down and bottom-up level. But with SAA, the more bottom-up portfolio-level considerations are more difficult to address when goals are tied to returns relative to benchmarks and tracking error.

Finally, the principles of universal ownership are far easier to implement using a TPA because of the integrated nature of managing a total portfolio of assets and liabilities with externalities and other factors (notably climate change) alongside[3].

"...it is worth noting that under a TPA, the implementing manager has more scope to add value in absolute terms, by contrast the implementing manager is more restricted to alpha when operating a SAA."

[3] Universal investors (aka universal owners) – Asset Owners (AOs) and Asset Managers (AMs) – are very large investors that aim to achieve real-world impacts on the environmental / societal system and better outcomes for beneficiaries. Relatively few asset owners have self-identified as being universal owners (eg GPIF from Japan, GPF from Norway, CalPERS from U.S.), but increasing numbers of funds apply universal owner strategies and have a universal owner mindset. For a definition of universal owners see: *Urwin, Pension Funds as Universal Owners; Opportunity Beckons and Leadership Calls | Rotman International Pensions Management Journal | Spring 2011.*

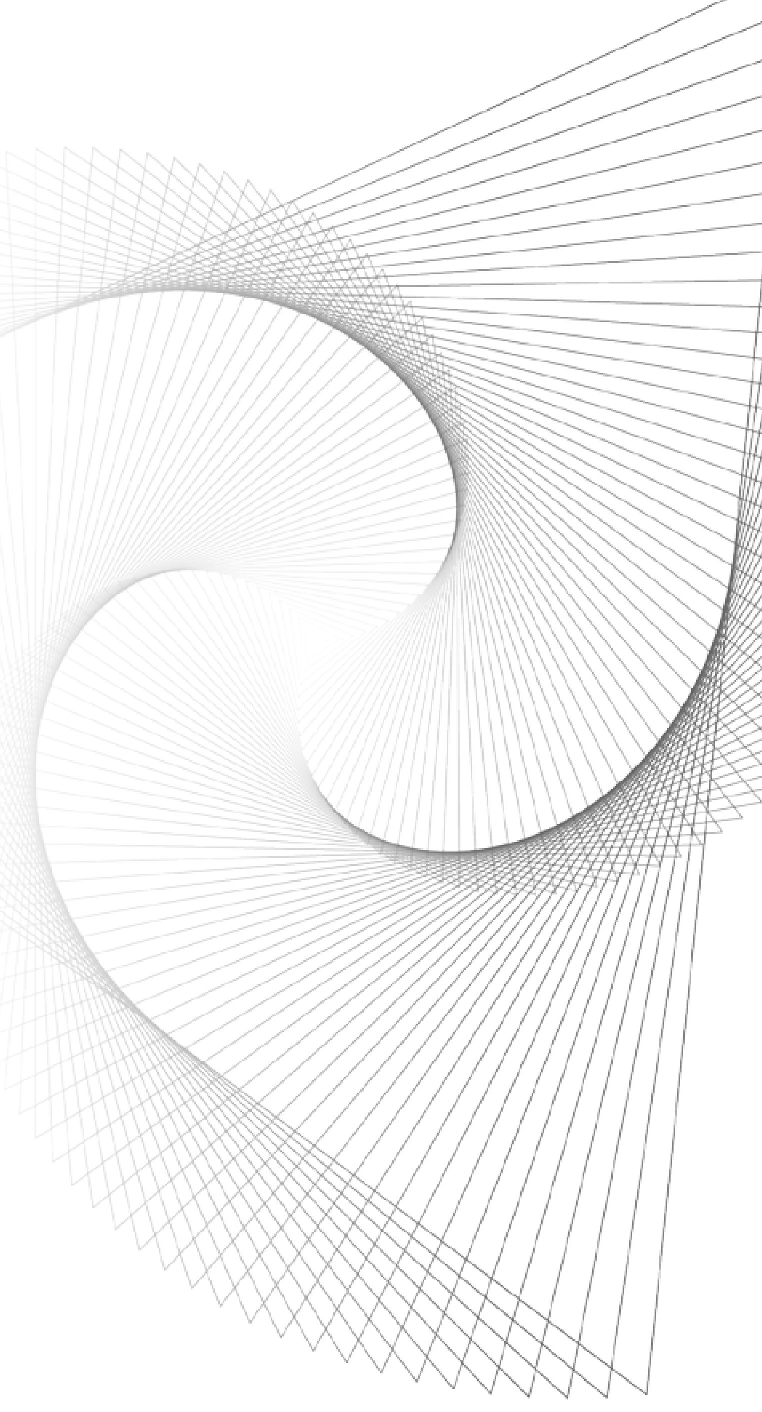
"*The core idea of a universal owner is a large institution investing long-term in widely diversified holdings across multiple industries and asset classes and adapting its investment strategy to these circumstances*".

Several pragmatic arguments for SAA

SAA has reasonably strong governance support in Boards and Investment Committees (ICs) and so the motivation to change to TPA may be limited

Most ICs and Boards have grown comfortable using SAA arrangements as part of their governance process and see it as working effectively enough overall. For this reason, the status quo in existing SAA arrangements seems to be set reasonably strongly, particularly as AOs are nervous of large-scale change. Understandably, as they have limited experience of managing change projects and are generally time-challenged in relation to undertaking such a process.

An AO's governance capacity is often referred to as the *governance budget* – the quantifiable resource available to take decisions – which is a function of time, expertise and organisational effectiveness. In instances where the governance budget is small, the capacity to handle a successful transition to a TPA is correspondingly small, notwithstanding the benefits of doing so.



TPA is heavily reliant on establishing a collaborative culture and an effective organisational design

For an effective collaborative culture to work in a TPA framework, the organisation requires leadership to provide a vision and strategy that demonstrates and supports the benefits of working together. Such a state can be compromised by weak communications, poor behaviours and other limitations. A particularly good account of how organisations can fail to achieve effective teamwork is given in Patrick Lencioni's *Five dysfunctions of a team* where it is explained how individuals and groups need to be results-focused, accountable, committed, good-with-conflict and trustworthy. If these characteristics are not present, transitioning to a TPA could be risky and there may be less at stake with existing SAA arrangements.

The regulatory framework and communication with end investors can make the SAA a useful construct

In certain markets the SAA acts to communicate the expectations of an investment portfolio more accurately, whereas reference portfolios communicate this more lightly. For example, in Australia, the SAA approach has become a standardised construct to help performance comparison and is part of the forthcoming Your Future Your Super regulatory guardrails. These parameters do not preclude the use of a TPA but they suggest some codification process is required across three portfolio types: the reference portfolio, the SAA portfolio and the actual portfolio.

Chapter 3: The tough questions on TPA

There are a few key questions AOs should ask themselves when considering how a TPA could fit with their investment arrangements. While every AO has a unique context, we believe there are four building blocks (Figure 3) to consider when answering these questions. These points are covered in a checklist in Appendix I.

1 Align thinking: Deepen total portfolio thinking and methodology

Essentially this means the decision-making process is aligned to fund goals and *joined-up* with a portfolio in which all investment opportunities compete for capital. This principle – in full or in part – is a cornerstone of TPA practice which is complemented by the other three building blocks. This building block sets a high bar in which relatively few funds in the world pass with distinction[4].

2 Align measurement: Create total portfolio dashboard

Monitor and adapt strategy by reference to dashboard in efficiency, resilience, sustainability and implementation (see Appendix for illustration) . This principle is that to ensure best practices the feedback should consider multiple measures of progress and sources of decision support. This is increasingly a focus of asset owners that seek better clarity and decision validation[5].

3 Align governance: Build and re-set internal spending

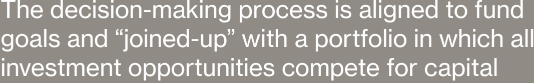
The key strategies involve making sure that the resources of the organisation are well-balanced internally and externally. Internal resources can be more aligned to the organisation's needs, external resources can be the only means to access the most specialised skills. Given current practices, this often but not always suggests increasing internal resources[6].

4 Align culture: Develop collaboration practices

The key focus is on building a culture of collaboration through a team approach in which goals are aligned and results are judged in context by team contributions. Such cultures will need the alignment of reward structures.

Figure 3 – **The best-practice building blocks**

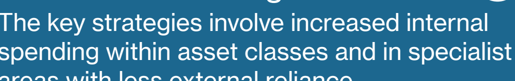
Align thinking:
Deepen total portfolio thinking methodology


The decision-making process is aligned to fund goals and "joined-up" with a portfolio in which all investment opportunities compete for capital

Align measurement:
Create total portfolio dashboard

Monitor and adapt strategy by reference to dashboard in efficiency, resilience, implementation and sustainability applying a system frame

Align governance:
Balance internal and external resourcing


The key strategies involve increased internal spending within asset classes and in specialist areas with less external reliance

Align culture:
Create the motivations and structures for collaboration

Culture of collaboration through a one-team approach in which goals are aligned and results are seen in context and backed up by reward

[4] Further reading: *Total Portfolio Approach (TPA). A global AO study* | *TAI* | *2018*

[5] *A Total Portfolio Approach* | WTW | 2020 | This describes the components in the dashboard (see Appendix II for illustration)

[6] See *Beath et al* | *The Canadian Pension Fund Model* |2020 | This sets out empirically the benefits of AOs spending more on internal direct resources (e.g. front-line investment professionals), more on internal indirect resources (e.g. IT infrastructure), less on external resources (e.g. outside managers), and less overall.

"There are some decisions best suited to a group, while there are others that should be one person's decision. The key is clarity of thinking, articulated in well written principles."

How do Boards overcome their inbuilt bias towards SAA?

There are three main pathways that AOs, which currently employ SAA arrangements, can choose from when progressing a TPA philosophy:

1. Employ greater TPA thinking within an SAA structure. The additional governance budget needed for this is modest
2. Progress to TPA via an outsourcing model employing an OCIO. The governance budget needed to implement a TPA model via an OCIO is only modestly more than needed to select the OCIO ('catching two birds with one stone')
3. Transitioning directly to TPA. The governance budget required here is large in order to adjust governance, culture and investment principles at both Board and Executive level.

The best path will vary by context and be driven by the fundamental governance principle of matching the resourcing available to the complexity and sophistication of the investment arrangements. This principle applies both in managing ongoing arrangements and in transitioning to new arrangements.

How can AOs design their decision rights and responsibilities optimally?

In an Institute research publication entitled Going from good to great, we emphasise that ICs, and any connected trustee Boards, need to focus on getting things done and may well decide delegation to an insourced or outsourced Executive is the best way to do that. It should not be the Board's or IC's role to get heavily involved with portfolio construction and asset allocation. For many AOs this involves seeing the merits of a shift in responsibility scaling down the Board and IC contribution to the investment strategy and scaling up their contribution to the overall strategy. This is about a strategic focus by the Trustee and IC on risk, goals and resources, not on the choice of asset classes.

In that publication, the second emphasis is on the IC – and any connecting Board – having the critical role of establishing the resourcing model and governance framework covering responsibilities and accountabilities – the decision matrix. Boards and ICs must match their chosen responsibilities and delegations to their own skills and identification of the skills of their Executive and AM line-up. Time spent on this to build a clearly articulated and understood framework is key. There are some decisions best suited to a group, while there are others that should be one person's decision. The key is clarity of thinking, articulated in well written principles. See the **TPA transition roadmap** in chapter 4 for more details.

What qualities of culture and leadership are needed for TPA success?

The key cultural attribute needed for a TPA is one that emphasises collaboration towards a shared purpose and set of goals. In that context, this is a 'one-team' culture with: high levels of mutual trust; high levels of support for colleagues; seeing progress at the group level not the individual level; equality of voice; and personal and group accountability.

Serving styles of leadership, in which the focus is on how leadership helps others in the group through coaching or other development activities, are most effective in a one-team culture. Leadership also sets the tone and should aim at creating the conditions for ideas to surface and to be explored and for all efforts to be aligned to the group goals. This is in essence creating safe psychological spaces.

How much nimbleness should funds pursue in their dynamic allocation?

The decisions that can be taken in a TPA allow for significantly more nimbleness and associated active risk (relative to the reference portfolio), than is possible in SAA arrangements. The issue of how much of this potential for nimbleness is employed in practice is another question reflecting governance budget, beliefs and comparative advantage.

Some AOs use the term Dynamic Strategic Asset Allocation (DSAA) for nimble strategic re-positioning of their funds. In DSAA arrangements, funds can scan the opportunity set for valuation anomalies in asset classes using methods similar to macro hedge funds. Their ideas for possible DSAA positions may also come from outside firms in their manager line-up. Of course, DSAA could be applied to both SAA and TPA arrangements, but the governance needed in SAA to combine successfully with DSAA is challenging.

How do AMs help AOs that are implementing a TPA?

Relationships between AOs and AMs have not generally had high levels of engagement and collaboration. In a TPA there is scope for more collaboration in exploring ideas together, such as:

- AMs suggesting a new mandate and AOs refining the proposition to suit their fund's total portfolio
- AOs identifying a new investment idea with AMs refining the idea into a mandate
- AOs explaining their total fund philosophy enabling AMs to identify better where their skills might best contribute to the portfolio.

The underlying philosophy is that AMs should try to understand their value add less in terms of their alpha efficiency (internally defined) and more in terms of their contribution to the AOs total portfolio efficiency (externally defined).

Can sustainability be managed better with TPA?

The clue to this lies in how a TPA can deal with policy and implementation at the same time – both the top-down and bottom-up considerations. But with SAA the more bottom-up portfolio level considerations are more difficult to address in the portfolios when goals are tied to returns relative to benchmarks and tracking error. A good example here is in 3D investment mandates (i.e. covering risk, return and impacts). As outlined in chapter 2, TPA arrangements can use the implementing manager in the broader area of adding value (not confined to 'alpha') and thus enable the integration of all sustainability factors at both a top-down and bottom-up level.

Another example lies in the management of externalities in the total portfolio when taking a universal ownership perspective. As one portfolio (or one asset) may produce the externalities that another portfolio incurs as explicit costs, any attempt to diminish the consequences of externalities is better placed at the total portfolio level with joined-up thinking, not at the individual sector or security level.

For those investors with net-zero targets and seeking to make a positive impact through their investing, they must employ a range of integrated actions to contribute to overall risk and sustainability goals, with metrics like carbon intensity and climate VaR. These actions include using portfolio allocation; exposure to climate solutions like renewable energy, energy efficiency and carbon capture; and impacts via engagement with investee companies on their carbon transition plans.

This need for integrated actions around sustainability, and especially climate-related initiatives is aligned with TPA methodologies, but is harder to implement under an SAA framework.

"For those investors with net-zero targets and seeking to make a positive impact through their investing, they must employ a range of integrated actions to contribute to overall risk and sustainability goals, with metrics like carbon intensity and climate VaR."

Chapter 4: A roadmap for transitioning to TPA

The adoption of a TPA can represent a significant practical and cultural change from an AO's existing approach and so we suggest that it should be implemented incrementally, rather than by adopting a *big-bang* approach. Pilot versions or graduated adoption of TPA elements (to enable their testing in real time) can help Boards to get comfortable. While there is no single best way of implementing it, some AOs that are more advanced in applying a TPA have often had a significant catalyst or impulse that led to change, such as having a blank sheet of paper, or a commitment to a burning-platform change programme. The following roadmap elements are helpful in progressing towards a TPA.

Crafting the objectives

The organisation needs to be united in the agreement of objectives that are specific and measurable, identifying absolute and relative targets, and that are time specific. Ultimately this specification is a matter for the Board to determine as the highest authority in the organisation. The Board's agreement needs to be followed by socialising and getting buy-in throughout the organisation.

Enhancing the governance model

A critical part of the governance model is having the governance budget in place. A critical change is the evolved role for the Board to scale down the *investment strategy content* (moving from having responsibility for the policy portfolio to the reference portfolio) and to scale up the *fund strategy context* (focusing on mission, stakeholders, risk, time horizon and resources). We observe that the delegations employed by the Board may also warrant a change so that the Executive resourcing necessary is in place via internal teams or a delegated OCIO (outsourced chief-investment officer) arrangement.

Enhancing the investment model

As described earlier, two key components of the investment model under a TPA are the portfolio classification process by specifying the asset classes, risk factors and other groupings that the portfolio will allocate to and by assessing the quality of the resulting portfolio through a dashboard that supports the allocations to be made reflecting the thinking and belief systems of the organisation.

Specifying the portfolio construction process and assessment of success

By clear identification and documentation of its process, an organisation can ensure consistency over time whatever the investment conditions or organisational circumstances. Written statements of process should always be centred on a decision matrix, where the exact nature of each contribution is spelled out in terms of types of accountability for the various parties concerned.

Work on the soft factors

One component that needs to be well developed is that of a collaborative culture and a collective sense of accountability for the results. Enabling a collaborative culture which balances the tension between individual and group decision making and strategic and real-time decision making requires effective decision-making frameworks to be set up and incentives to support TPA accountabilities.

Integrate the motivations

TPA accomplishments can be shaped into KPIs via the performance reviews of the Executive team and the Board-assessment process. The communication of the TPA and in particular the fund's goals should be given special priority in the organisation signalling its importance, with performance relative to TPA goals being a contributor to compensation.

Chapter 5: Conclusions

AOs and AMs contemplating a move from a SAA approach to a TPA will need a combination of *time*, coupled with a strong *vision* and *change process* for a successful transition. And they will need a sense of perspective on the industry context for these trends to materialise.

Time

The principal revisions needed are to beliefs and behaviours. These are qualities that simply cannot be rushed and, in our experience, any change process is likely to last at least a year and possibly considerably longer.

Vision

It is critical that there is a strong vision for the change, particularly concerning the streamlining of governance and the positive consequences. This calls for leadership of the highest order.

While individual circumstances vary, the vision will often contain a mix of arguments and beliefs:

- that annual returns can be enhanced by a significant and sustainable amount;
- that the risk management and sustainability practices can be improved;
- and, that there should be positive changes in organisational culture and sustainability.

Process

Strong process for TPA transition will need to be well-planned but at the same time agile to developing circumstances.

While process will reflect exact fund circumstances, we suggest that trials or phasing in arrangements may have a place to build stakeholder confidence.

The context. Where this is heading

Despite some high-profile examples of successful implementation, total portfolio thinking is still in the early stages. But its enviable characteristics and outcomes are leading to changes where we see three distinct aspects of this.

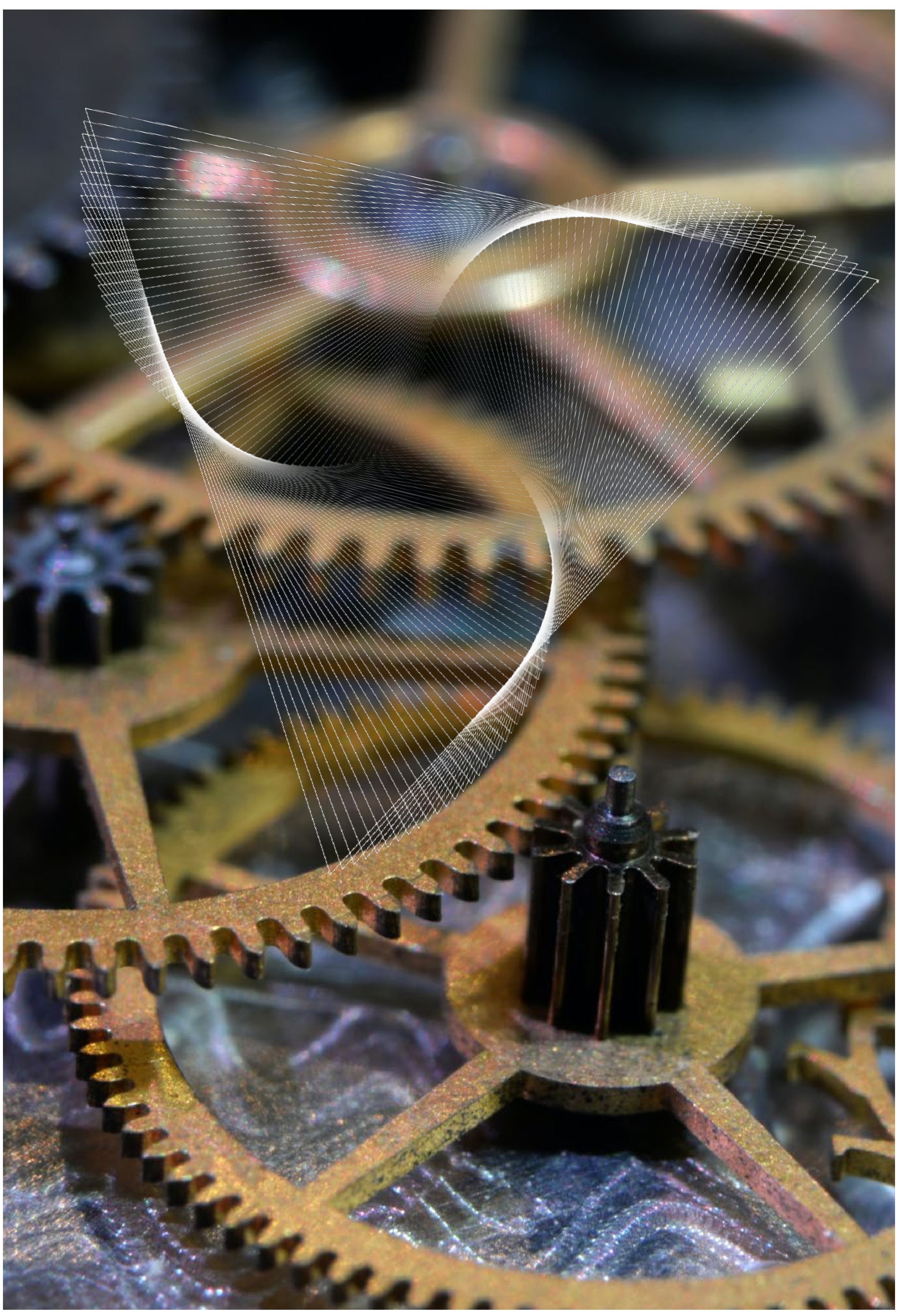
1. Many AOs use SAA arrangements effectively and successfully, but this does not mean that they cannot benefit from total portfolio thinking.

2. For many funds with SAA arrangements there are acknowledged shortcomings in this model that would be improved by moving to TPA arrangements. Notably reaping the considerable benefits of making better use of time and being nimbler over time. Those AOs transitioning to a TPA represent a positive forward step and, simply put, will be more able to achieve their goals particularly in a rapidly changing industry where more stakeholders are involved and multiple agendas require juggling. The applications of TPA to sustainability are particularly resonant.

3. This is a development that is not subject to win-lose considerations – all funds can benefit together in adopting such practices so we can foresee industry-wide approval of these trends.

These factors mark out an S-curve innovation, starting slow, and accelerating as early adopters validate the approach by demonstrating success. So, we expect a growing number of the well-governed AOs – that are well-resourced, well-supported and strategically focused – will make the transition and contribute to a quiet revolution in investment practice.

"Despite some high-profile examples of successful implementation, total portfolio thinking is still in the early stages."



Appendix I:

A total portfolio best-practice checklist

Category	No.	Checklist item
Total portfolio thinking	1	Our actuarial funding and investment goals are aligned
	2	Our fund is not unduly influenced by benchmarks
	3	Communication of our results focuses on measures of long-term success
	4	Sustainability considerations that contribute to meeting our financial goals are weighted appropriately
	5	Impact considerations that contribute to meeting our non-financial goals are weighted appropriately
Total portfolio dashboard	6	Our forward-looking risk models are well calibrated and carry short- and long-term considerations
	7	Our performance attribution produces a clear picture of the different contributors to good / bad performance
	8	We have quality data and measures identifying our internal team's performance and accountability
	9	We assess investments for portfolio inclusion even if they sit outside of defined asset classes
	10	We have good data to evaluate our capital allocation choices
Align governance	11	Our fund is able to move quickly to change allocations when investment conditions change
	12	Our internal resources are adequate given our size and organisational preferences and beliefs
	13	We effectively incorporate inputs from outside advisers and managers
	14	Our strategy decisions are considered by an investment committee that has effective governance
	15	We surface strategy considerations from integrated team views as opposed to by sectoral perspectives
Align culture	16	Our compensation and incentives are fully aligned to the value and success outcomes of our fund
	17	Our culture is to judge results in context, not attribute simplistic causal explanations
	18	Our culture is to collaborate and value team success ahead of individual success
	19	We strike a good balance in considering short-term and long-term goals and progress
	20	There is an alignment between our board and executive in which each entity plays to their roles and strengths

Appendix II:

A portfolio quality dashboard illustration

Dimension	Metric	SAA illustration	TPA illustration	SAA illustration	TPA illustration
Return	Expected return vs cash (% pa)	3.0%	4.6%	The SAA Model is based principally on these 6 factors	The TPA Model is based on 12 factors
Risk	Volatility (% pa)	7.5%	7.3%		
Efficiency	Sharpe ratio	0.40	0.63		
Relative risk	SAA/TPA relative risk	1% - 3%	3% - 5%		
Diversity	Equity beta	0.63	0.37		
Low cost	MER	0.23%	0.54%		
Stability in stress	Expected stress loss (% pa)	26%	18%		
Sustainability	ESG risk exposure (/100)	33	23		
Climate	Implied Temperature Rise	2.8°C	2.5°C		
Flexibility	% daily liquid	10%	26%		
Access to skill	% contribution from skill	6%	31%		
Governance	Oversight complexity	4/5	3/5		

Notes

- Prepared for illustration of the dashboard concept only using specimen portfolios. There is no direct comparison possible between the SAA and TPA data as these are just point of time exhibits.
- It is critical to see how the TPA arrangements focus on a range of goals and need this quantitative support to identify portfolio quality and suggest portfolio changes.

Key: fully aligned to goals · mostly aligned to goals · partially aligned to goals · somewhat misaligned to goals

Limitations of reliance

Limitations of reliance – Thinking Ahead Group 2.0

This document has been written by members of the Thinking Ahead Group 2.0. Their role is to identify and develop new investment thinking and opportunities not naturally covered under mainstream research. They seek to encourage new ways of seeing the investment environment in ways that add value to our clients. The contents of individual documents are therefore more likely to be the opinions of the respective authors rather than representing the formal view of the firm.

Limitations of reliance – Willis Towers Watson

Willis Towers Watson has prepared this material for general information purposes only and it should not be considered a substitute for specific professional advice. In particular, its contents are not intended by Willis Towers Watson to be construed as the provision of investment, legal, accounting, tax or other professional advice or recommendations of any kind, or to form the basis of any decision to do or to refrain from doing anything. As such, this material should not be relied upon for investment or other financial decisions and no such decisions should be taken on the basis of its contents without seeking specific advice.

This material is based on information available to Willis Towers Watson at the date of this material and takes no account of subsequent developments after that date. In preparing this material we have relied upon data supplied to us by third parties. Whilst reasonable care has been taken to gauge the reliability of this data, we provide no guarantee as to the accuracy or completeness of this data and Willis Towers Watson and its affiliates and their respective directors, officers and employees accept no responsibility and will not be liable for any errors or misrepresentations in the data made by any third party.

This material may not be reproduced or distributed to any other party, whether in whole or in part, without Willis Towers Watson's prior written permission, except as may be required by law. In the absence of our express written agreement to the contrary, Willis Towers Watson and its affiliates and their respective directors, officers and employees accept no responsibility and will not be liable for any consequences howsoever arising from any use of or reliance on this material or the opinions we have expressed.

Copyright © 2021 Willis Towers Watson. All rights reserved.

Contact details

Roger Urwin
roger.urwin@willistowerswatson.com

The Thinking Ahead Institute

About the Thinking Ahead Institute

Mobilising capital for a sustainable future.

Since establishment in 2015, over 65 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.

Join the Thinking Ahead Institute

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

Paul Deane-Williams
+44 (0)7734 342139
paul.deane-williams@willistowerswatson.com

About the Thinking Ahead Institute

The Thinking Ahead Institute seeks to bring together the world's major investment organisations to mobilise capital for a sustainable future. Arising out of Willis Towers Watson's Thinking Ahead Group, formed in 2002 by Tim Hodgson and Roger Urwin, the Institute was established in January 2015 as a global not-for-profit group comprising asset owners, investment managers and service providers. Currently it has over 45 members with combined responsibility for over US$12trn.

Towers Watson Limited (trading as Willis Towers Watson) of Watson House, London Road, Reigate, Surrey, RH2 9PQ is authorised and regulated by the Financial Conduct Authority.

Copyright © 2021 Willis Towers Watson. All rights reserved.
TAI-IC020/08/2021

thinkingaheadinstitute.org

Thinking Ahead Institute
Willis Towers Watson