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PRIVATE EQUITY

How leading institutions are changing the rules on portfolio construction

The world's largest investors are determined to make the leap from big to great. Getting there will depend on a new understanding of strategic asset allocation.

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Institutional investors are now recognized as essential players in the global financial system. The largest pensions and sovereign-wealth funds manage more than $1 trillion, and they get the respect that such sums command. However, many analysts, partners, suppliers, and leaders within the industry are unclear about where these institutions are headed. It's obvious that they are not simply pools of capital and collections of talent. But it's not so obvious how they will deploy their capital and change their investing practices.

To find out, we surveyed more than 50 senior executives at more than half of the top 50 pensions and sovereign-wealth funds worldwide, which collectively manage $7.4 trillion in assets. We also interviewed leaders of these institutions in depth and solicited the views of our colleagues around the world who work with leading investors. The research revealed two themes that turned up again and again. First, the world's leading investors are intent on evolving into true institutions that are more than the sum of their parts. Second, a reexamination of the portfolio-construction process has become the top priority for many of the CEOs and chief investment officers (CIOs) we interviewed.

The importance of portfolio construction is not a new idea—far from it. Various academic studies over the past two decades have found that approximately

90 percent of variation in a fund's returns over time, and about 35 to 40 percent of the differences in performance between one fund and another, are attributable to asset-allocation decisions. What our research revealed as new, however, is that traditional approaches to asset allocation are now seen to be inadequate, and CIOs and CEOs are increasingly willing to rethink these approaches and their process.

Until recently, strategic asset allocation (SAA) has been rather nonstrategic. Most institutions used historical estimates of returns, correlation, and volatility, plugged in relevant constraints, and generated a frontier of portfolio options that theoretically matched their risk and return objectives. Because the estimates and constraints changed very little, last year's allocation became a powerful anchor for this year's. Significant adjustments to strategic asset allocation have been rare, with the exception of a long-term trend among many institutions to shift more of their portfolios to illiquid assets.

Indeed, for most pension and sovereign-wealth-fund boards, the review of asset-allocation decisions has been more or less a rubber-stamping exercise.

Instead of working on SAA, many institutions have focused the bulk of their time on searching for alpha through a number of means, including active management (both internal and external) and direct investing in illiquid asset classes. The work on beta has been mainly to reduce costs, often through internalizing management, with some exploration of enhanced-beta portfolios. Our survey and interviews confirmed that institutions generally spent 20 percent of their time on beta, including strategic asset allocation, and 80 percent on the search for alpha.

In the biggest change to affect investing recently, leading institutions are realizing the implications of this mismatch. Low interest rates have added considerable capital to the global financial system, pushing up prices on all kinds of assets and effectively lowering risk premiums. Hitting "repeat" on strategic asset allocation from year to year has had the unforeseen consequence that institutions are not being paid for the risks they are taking. That's costly: the payoff from getting SAA right is worth a decade of good deal making to create alpha at the margin.

To bring rewards in line with risks, institutions are trying various ideas. With risk premiums so low, some investors have considered going to the extreme of allocating more of their portfolio to cash. Australia's Future Fund is one; it raised cash levels to more than 20 percent of the portfolio at the end of 2015. However, most institutions have limitations that prevent them from doing this. Many are exploring other approaches, such as factor-based investing. This investment style is accelerating rapidly. By one estimate, the assets under management dedicated to this approach have quadrupled over the past three years.

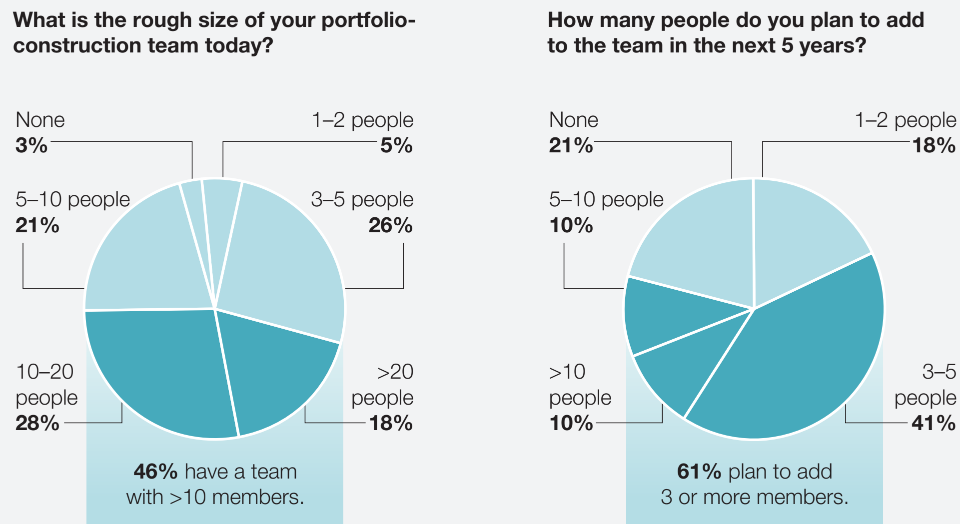
By far the most important change, however, is coming to the 80/20 alpha/beta management approach. Institutions plan to change those proportions by focusing on building portfolio-construction capabilities, given that these drive the vast majority of long-term returns. The most striking finding from our research is that almost 80 percent of institutions plan to reinforce their central portfolio-construction team, with most expecting to add three to five people (Exhibit 1). In interviews, leaders also said they expect a more dynamic decision-making process structured around top-down economic scenarios, which they hope will provoke more debate and move them away from a rote approval of strategic asset allocation by the executive committee and board.

What will this central team focus on? We found broad evidence that SAA will be increasingly driven by deeper insights from the institution's liability

Exhibit 1

Most institutional investors are planning to expand their teams over the next five years.

Respondents, %



Source: McKinsey survey of limited partners, 2015

profile. Seventy-five percent of respondents think that they already understand well (or in a distinctive manner) their liability profile. And yet 92 percent plan to invest further. More than 60 percent say that liabilities drive their major investment decisions, a figure that is certain to rise as institutions invest more in understanding just what they owe to their stakeholders (Exhibit 2).

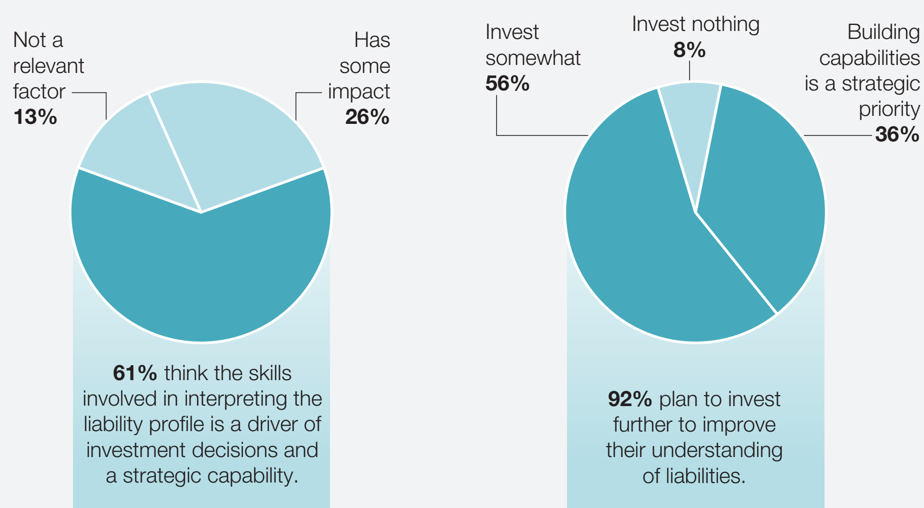
What they do with that better understanding depends on what kind of institution they are. Big defined-benefit pension plans may be furthest evolved; they have an actuarial understanding of their depositors. But even these funds can learn more about the composition of their depositor base, to get beyond raw demographics and into depositors' preferences and their exposures from their other assets. Indonesian public servants, for example, already have exposure to the domestic economy from their homes, work, families, and other investments; should their pension fund be overweight on Indonesian equities? Also, only a handful of leading institutions do a good job of proactively managing the duration risks that arise between their beneficiaries' needs and their investment activities.

Defined-contribution pension plans can use a better knowledge of their depositors to serve them with products that suit them better, including target-date funds. Sovereign-wealth funds already use a long-term investment horizon, suiting their constituents' needs. But some may now need to think about how funds are used across all national budgets. For example, many resource funds have to grapple with the volatility and collapsing prices of commodities,

Exhibit 2

Institutional investors plan to shift toward liability-aware and liabilty-driven investing.

Respondents, %



Source: McKinsey survey of limited partners, 2015

especially oil. National budgets designed to allocate revenues from oil at $100 a barrel now have to be redrawn, with serious implications for reserve funds. Namely, sovereign-wealth funds will need to adjust their allocations based on the funding needs of their states, which in large part will be driven by oil prices.

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Our research turned up other ways that leading institutions will evolve, including new ways to define asset classes and changes in illiquid investment management. In the next issue of *McKinsey on Investing*, we will look at these developments. Taken together, the changes are expected to help leading institutions make the leap from big to great and herald the next era in institutional investing. ■

Download the full report on which this article is based, *From big to great: The world's leading institutional investors forge ahead*, on McKinsey.com.

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