



The Best of Times and the Worst of Times for Institutional Investors

How institutional investors should adapt their strategies to the new investment landscape

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August 2011

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Preface

These are the best of times and the worst of times to be an institutional investor. Though 2010 has delivered some respite for most institutions, portfolios by and large have yet to fully recover from the 2008-2009 crisis, and many global risks continue to loom on the horizon. Indeed, there is an undertone in the discourse of most institutions, and throughout the broader investment community, that the other shoe has yet to drop.

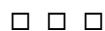
Massive fiscal deficits, combined with the threat of prolonged unemployment in developed markets, the risk of currency wars, political instability in certain parts of the world, and the potential for overheating in the emerging markets are all risks that can deeply affect institutional investors.

On the positive side, markets have rebounded strongly from their lows in March of 2009, particularly in developed countries, whose economies appear to be stabilizing. Emerging market economic growth continues to show robust momentum and these markets are giving rise to new global industry champions. These trends create opportunities for institutional investors, provided they have the right tools and capabilities to identify and capture them.

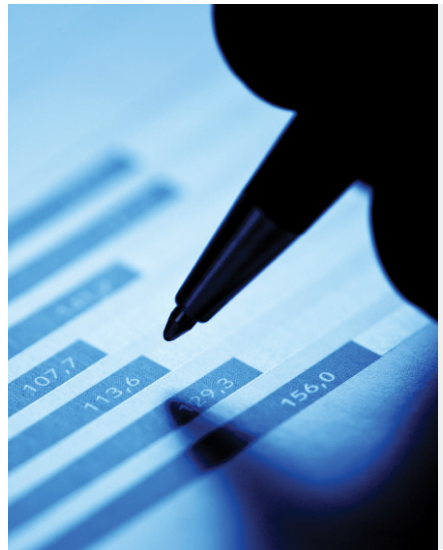
Despite widely varying points of view and concerns, the consensus of CEOs, CIOs, investment managers, and economists is that the near-term future holds almost unprecedented levels of both uncertainty and opportunity for global investors.

We believe that the next decade will be far different from the last, and will lead to a dichotomy among institutional investors, with increased separation in performance among investment institutions. Many institutions are fundamentally adapting their business models to post-crisis realities, while others "tweak" at the margin, without addressing the fundamental issues at hand – only time will tell which strategy will lead to superior performance.

The objective of this paper is to provide senior executives from institutional investors with fresh perspectives on approaches that institutions should take to navigate the shifts in the investment landscape. It is based on work conducted with leading global institutional investors as well as a series of discussions with over 50 industry experts and investment professionals of institutions collectively managing more than \$3 trillion in assets.



The authors wish to thank colleagues Peter Bisson, Jon Garcia, Aly Jeddy, Robert Palter, Gary Pinkus, Jean-Marc Pouillet, Diaan-Yi Lin, Vincent Bérubé, Bryce Klemperer, and Paulo Salomao for their support in this effort.



The Past Decade

Began with a bang and ended with a whimper

The past decade started with the internet bubble and ended with the bursting of the credit bubble. Sometimes referred to as the “lost decade” by investors, it was the first time in recent economic history that household net worth and net job growth remained flat for a period of 10 years in the United States. It also started with a recession and ended with a recession, this time more contained to the developed world, a consequence of the slow but real economic decoupling taking place between the developed and developing economies. The past decade also started with a series of corporate scandals and bankruptcies such as Enron and Worldcom and ended similarly with the Madoff case, the Lehman bankruptcy and unprecedented state interventions to limit the downward spiral resulting from the credit crisis, demonstrating – once again – the evolving challenges facing regulators in providing adequate oversight and monitoring of financial markets.

But between the beginning and the end of this decade, the intervening years were for the most part marked by what can best be described as a “global exuberance”: growth was global and robust, in stock markets and housing markets, while credit was cheap and abundant. It was also a decade of globalization, where trade of goods increased by 8.8 percent on average and cross-border foreign assets expanded by 9.4 percent, to reach \$92 trillion, the equivalent of 1.5 times 2009 world GDP. The concept of BRIC countries appeared during that period and the macro-economic environment of many emerging economies became such that international investors started to flood these markets with new waves of capital. New “power brokers” such as PE firms and hedge funds saw their influence on financial markets significantly increased and financial innovation – from product design to trading platforms – brought finance into a new era.

It was also the period where “institutional investing” rapidly modernized. As outlined in McKinsey’s 2009 report *The Best Practices and Next Practices of Institutional Investors*, institutional investors rapidly invested in and developed their front- and middle-office capabilities to capture new investment opportunities and sources of “alpha.” Many institutions started to further diversify their portfolio both from an asset class and geographic standpoint. They slowly but surely increased their allocation to illiquid asset classes as well as to absolute return strategies. Investment approaches such as “core-satellite,” “alpha factories,” or “portable alpha” – initially designed for institutions with very specific characteristics – became widely adopted across the industry. More institutions started to build internal management teams aiming at generating alpha across all asset classes. Many institutions also started to use various forms of leverage and sophisticated derivatives strategies to boost their returns and hedge their liability risks.

The crisis of 2008-09 shocked many institutions. Collectively losing more than \$500 billion, pensions and sovereign wealth funds realized – in many cases – that

- their investment strategy was neither optimally designed to meet their fundamental objectives nor adapted to their existing capabilities
- their lack of coordination – and sometimes discipline – around the use of leverage and derivatives could translate into severe liquidity crisis, forcing them to take on additional losses to respond to margin calls and avoid a default situation
- their risk management practices were not able to catch up with the increasing level of sophistication of their investment strategies
- their research functions were not able to generate the insight required to help them fully protect themselves against the credit crisis and its ripple effect on other markets

- their internal governance framework was not providing the flexibility required to manage during turbulent times.

While institutions are still reacting to the lessons of the past decade, they also need to deal with a new challenge: the next decade promises to be both turbulent and full of opportunities. Their success during this time will depend not so much on their prescience as on their ability to position their portfolios and their organizations to adapt and capitalize on the unfolding changes.

The Next Decade

Six tectonic shifts in the investment landscape

The financial crisis of 2008-2009 marked the end of an era for global economies and financial markets. We believe the next decade will be notable for six tectonic shifts in the economic and investment landscape.

1. Global rebalancing: a shift in economic power from the developed to the developing world

During the next decade, GDP per capita will rise almost five times faster in developing economies than in OECD countries, and these economies will contribute approximately 50 percent of real GDP growth.

Unfortunately, this growth will not by any means imply easy investment decisions for institutional investors. In fact, equity returns show very little correlation with economic growth, in the near and medium term. Furthermore, valuation gaps in accessible equity markets have effectively closed, and some markets are at risk of overheating. In this context, a simple passive index investing approach could well yield disappointing results.

Though there will be no “free lunch,” the next decade will provide fertile grounds for strong investment returns in both liquid and illiquid markets for those institutions able to identify outperformers. These outperformers will increasingly be found in emerging markets. For equities, approximately 20 percent of top-quartile return on capital companies by sector came from emerging nations in 2000. Today this ratio stands at 30 percent, and we expect this trend to continue over the next 10 years (Exhibit 1). Also, the next

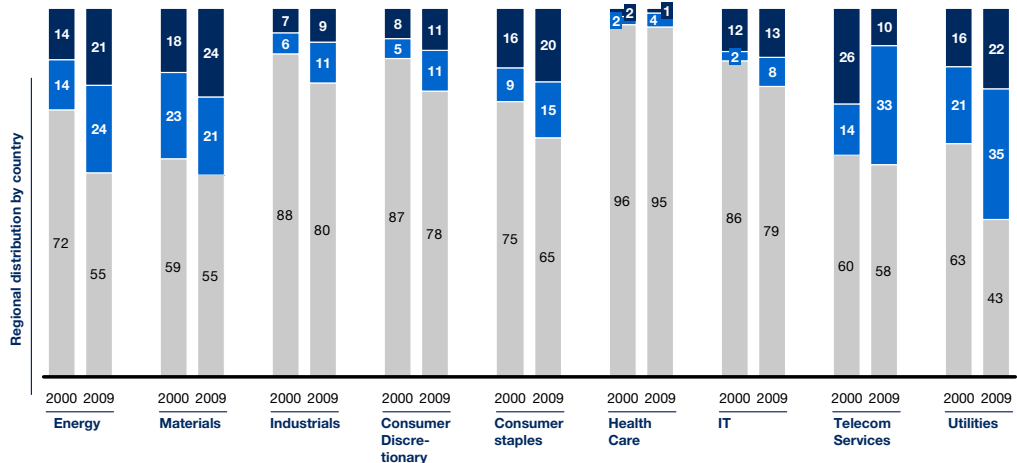
“People crudely associate economic growth with investment returns – the truth is that easy money is behind us now in emerging markets and prices are quite high”

– CIO, Asian Sovereign Wealth Fund

EXHIBIT 1

Emerging markets companies have gained share among the top global performers by sector

Companies with top-quartile¹ ROIC



1 Sample based on global companies with over 500M USD in revenue

SOURCE: CPAT; McKinsey Corporate Performance Analysis

decade will increase accessibility and maturity of emerging sovereign debt markets, though currency risk may continue to outweigh the potential for increased yield in most countries.

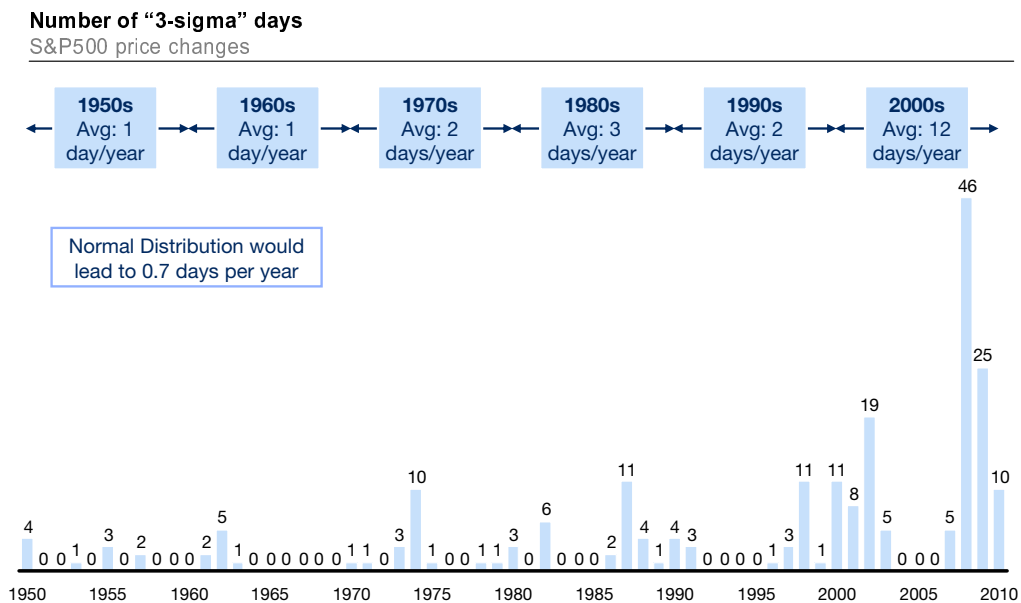
Trends such as the unprecedented wave of urbanization, demographic “dividends” in countries such as India, and the rise of the middle-class consumer will create significant opportunities in private equity, real estate, and infrastructure. The question for institutions will be how to identify and deploy capital against these opportunities, while effectively managing risks.

2. Capital markets: fatter tails, more frequent bubbles, and more expensive capital

From the past decade through early 2011, returns became increasingly dispersed, correlations significantly changed, and distributions were “flatter.” Given the ease with which large pools of capital can flow between asset classes and geographies, and the increased uncertainty around government intervention and regulation, as well as the rise of high-frequency trading, this shift may very well prove to be secular, rather than cyclical. The recent crisis has shown that capital-market interconnectedness is both a boon and a threat: while market liquidity and efficiency has increased, this increasing interconnectedness could also lead to larger and more frequent asset bubbles, exposing institutional investors to increased variability in performance (Exhibit 2).

EXHIBIT 2

Capital markets are in an era of fatter tails and more frequent bubbles



SOURCE: Standard and Poor's; McKinsey analysis

In this environment, historical rules of thumb and mean reversion strategies will be challenged. The increased competition for assets generating stable inflation-protected cash flows may drive down risk-adjusted returns for most asset classes, especially traditional safe havens. Furthermore, investors seeking higher yields while hedging their tail risk will quickly find that this insurance has become exceedingly expensive.

Last, the increasing AuM managed by institutional investors, as well as their increasing appetite for alternative assets, will continue to drive strong competition for deal flow, especially for larger deals, meaning these institutions will need to be creative in their approach to accessing attractive opportunities. This could mean looking for smaller deals and directly originating transactions to avoid auctions.

3. A massive deleveraging in developed economies

Developed-market governments will continue to feel tremendous pressure on their balance sheets. Government debt-to-GDP ratios have soared above 90 percent for many developed-economy governments and above 60 percent for emerging economies. Worse still, fiscal imbalances have become completely unsustainable. According to the IMF, closing the fiscal gap in the United States would require an annual fiscal adjustment of as much as 14 percent of U.S. GDP. By comparison, federal personal income taxes in the U.S. total approximately 7 percent of GDP.

Compounding this difficult fiscal situation is the specter of significant future government liabilities. Aging demographics will create extraordinary pension and healthcare costs, and prolonged unemployment will have a similar effect on welfare costs while reducing tax revenues. The IMF estimates that in net present value terms the cost of aging is as much as 4 times the GDP for G20 countries, or approximately 10 times the cost of the recent crisis.

With these forces in play, the unavoidable conclusion is that governments will need to deleverage – and deleverage fast. We expect that the current deleveraging process in developed markets to last 6 to 7 years, and that it will reduce the ratio of debt to GDP by 25 percent. Deleveraging has only just begun in most economies, and so far has been focused on shifts in leverage towards public balance sheets, rather than true reductions in total debt versus GDP.

Institutional investors will need to consider the various implications of deleveraging on both their current portfolios and future shifts in their asset allocation.

4. The increasing role of the state

At the height of the financial crisis, in the last quarter of 2008, U.S. and European governments purchased a combined \$2.5 trillion of public debt and troubled assets from banks, the largest monetary policy action in world history. Furthermore, state interventions in troubled financial institutions, as well as regulatory changes such as Dodd-Frank and Basel III may signal a bolder, more interventionist government position.

We believe that institutional investors can expect, over the next decade, a continuation of greater government involvement in the capital markets. This will be driven by a variety of forces, which include a desire to address national economic challenges (e.g., competitiveness or income inequality) and an increased skepticism around the market's ability to police itself. We expect these government interventions to take a series of forms, including larger and more frequent open-market operations, more significant monetary policy actions, and enhanced financial regulation. This last issue of increased regulation and oversight may well increase costs for investment institutions and drive returns down.

These interventions will create significant challenges for many institutional investors. For example, more volatile and less predictable interest rates affect institutional investors on both the asset and liability sides of the balance sheet. Unpredictable regulatory reforms can affect asset prices and change industries' attractiveness overnight. Understanding and adapting to a more assertive and active public sector will be a core theme over the next decade.

5. Energy, carbon, and commodities: learning to price the planet

Over the next decade, uncertainty in the supply and demand balance of natural resources and energy will create significant opportunities and risks for institutional investors. Demand for oil, iron ore, and other natural resources is expected to grow by over 30 percent in this period, with almost all of the new demand coming from emerging markets. However, these resources will become increasingly scarce and difficult of access, as existing reserves are depleted and geopolitical instability continues in areas of future supply, with the recent crises in the Middle East presenting a case in point.

In addition, the increased focus on environmental sustainability and an emphasis on carbon productivity will create an added layer of uncertainty. The cost competitiveness of various sources of supply will shift dramatically depending on when and how carbon costs are taken into account, a phenomenon that is already reshaping the cost curves of entire industries.

Though all of these forces point towards higher commodity prices, the reality for investors is that commodities fluctuate according to “super cycles” typically lasting 20 or 30 years, with significant price volatility within the cycles. Adding to the challenge, commodities have shown a drastic increase in correlations over the last decade, among themselves, and also with global equity markets, and these heightening correlations will likely continue.

6. Accelerating pace of industry transformation

Over the past 10 years, the metabolic rate of industry sectors and economies has been accelerating, and will likely continue on this trajectory. Entire industry structures are changing at a rate never seen before, driven primarily by two factors: 1) disruptive technologies, and 2) changing consumer patterns. These shifts will create both challenges and opportunities for institutional investors, in public and private markets.

Disruptive technologies have led to dramatic shifts in industry leaders. For example, the Dutch newcomer Skype appeared 8 years ago and is now the largest global carrier of transnational calls in the world – despite having no network infrastructure whatsoever. Furthermore, these technologies are also blurring industry boundaries, especially in areas like telecom and media. Larger incumbents will need to improve their foresight and the focus of their innovation investments to keep pace with these changes and also to capture opportunities.

Changing consumer patterns are also increasing the ambiguity within industry landscapes. Major shifts in the ways consumers make purchasing decisions, the sources of data they use, the types of offering they are looking for (e.g., more bundling, more solution-oriented offers) and the channels through which they make purchases are impacting many industries. Furthermore, the new middle class in emerging markets is very different from the developed-market middle class, and developed-market industry champions must completely revisit their offering if they hope to capture their share of this growth.

One of the important implications of these shifts for institutional investors has been the dramatic shift in margin from one end of the value chain to another in certain sectors, due to changing industry structures and conduct. For example, in 1995, iron ore and coking coal producers captured only 19 percent of steel industry margin pools, while today they capture 72 percent of an even larger pool. Institutional investors need to understand these underlying industry dynamics if they wish to deliver superior risk-adjusted returns over time.

Navigating the next decade

Twelve imperatives for institutional investors to adapt to the new investment landscape

Given these massive shifts in the economic and investment landscapes, we foresee the opening of a significant dichotomy among institutional investors over the coming decade. In our interactions with most of the world's largest institutional investors, we have been struck by the increasing divergence among the strategies and reactions to this changing landscape.

Though all the institutions agree that they need to adapt, they are employing vastly different strategies to do so. At one end of the spectrum, some institutions are tweaking their existing approaches, while at the other, some are completely rethinking their investments and operating models.

For senior executives of global institutional investors, we have identified 12 imperatives that we believe must be considered as they shape their efforts to adapt and respond to the changing investment landscape (Exhibit 3).

EXHIBIT 3

12 “shifts” for institutions to adapt to the new market landscape

Setting the course for the institution	<ol style="list-style-type: none"> 1 Get back to basics on investment objectives and focus on absolute return objectives with minimal risk, rather than maximizing risk-adjusted returns 2 Align benchmarks and incentives to <i>manage</i> for return objectives, but <i>measure</i> against the investable alternatives 3 Extend the investment horizon to align the investment strategy with true investment objectives, capture illiquidity premium and leverage a natural competitive advantage
Rethinking investment strategies	<ol style="list-style-type: none"> 4 Put the “strategic” back into asset allocation, adopting a more forward-looking approach and including a risk factor view to “fix” diversification 5 Develop innovative equity strategies, including long-term and thematic approaches, with a focus on company fundamentals, and bringing a PE approach to public equity strategies 6 Increase allocation but also value add in alternatives by focusing investments on fewer strategically aligned, value added external partners 7 Avoid the free lunch mirage of emerging markets, and re-focus strategies on the “how”, not the “what”, of the emerging market investing approach
Evolving organizational enablers	<ol style="list-style-type: none"> 8 Rethink governance structure, capabilities, and decision rights, to address added size and complexity of varying cultures between investment teams 9 Align risk management to evolution in strategies, developing a more collaborative approach, focused on value creation levers, while proactively addressing fat tail risks 10 Evolve research as a strategic priority by developing internal thought leadership, and increasing collaboration and dialogue with investment professionals 11 Refine the role and reach of the center in setting the investment philosophy and managing liquidity and leverage 12 Build a global ecosystem of partners to support strategy implementation

SOURCE: McKinsey's 2011 institutional investor benchmarking initiative; McKinsey analysis

Setting the course for the institution

1. Get back to basics on investment objectives

The vast majority of institutional investors have a clear investment objective: delivering a target rate of return (within a certain risk framework) required to meet their short- and/or long-term obligations. Over the past decade, many institutions lost sight of this fundamental objective. Indeed, rather than building an investment framework and organization aligned with this objective, many organizations were more focused

on beating a variety of benchmarks and/or peer indices. They often optimized at the sub-asset class level, leading to a sub-optimized overall portfolio. Worse, driven by misaligned incentives, many investment groups sought to maximize alpha regardless of market conditions. In some cases, the pressure to increase risk-taking came from boards, and in others from a poorly designed compensation program or lack of alignment of interests between the constituents, management and investment professionals.

We believe that it is time to get back to basics. Institutional investors should reassess what their fundamental investment objective is and align their strategy, processes, organization and culture to ensure that they maximize their chances of delivering on it. For many organizations, this thinking will translate into a radical paradigm shift: rather than a myopic focus on “beating the benchmark” or maximizing returns within a pre-established risk budget, they will aim at maximizing their chances of delivering their target returns (which may include alpha targets) within the smallest-risk budget possible.

Many institutions have realized the importance of reaffirming their true investment objectives and adapting their investment strategies. For example, some institutions have developed “all-weather portfolios” in order to deliver on absolute return objectives throughout different economic scenarios. Other institutions have developed an investment framework based on a reference portfolio used as a screening process to identify investment opportunities meeting their investment objectives on a risk-adjusted basis.

Whatever approach they use, we believe institutional investors need to reframe their investment strategies and performance measures to ensure tighter alignment with their over-arching investment objectives.

2. Extend the investment horizon

More than ever, top management of investment institutions need to push their organizations to develop a longer-term investment horizon. The definition of “long term” will vary for each institution: a SWF aiming at building wealth for future generations with no short-term liabilities can deploy capital in a more patient way than a pension fund with negative net flows, responsible for making monthly disbursements to plan sponsors.

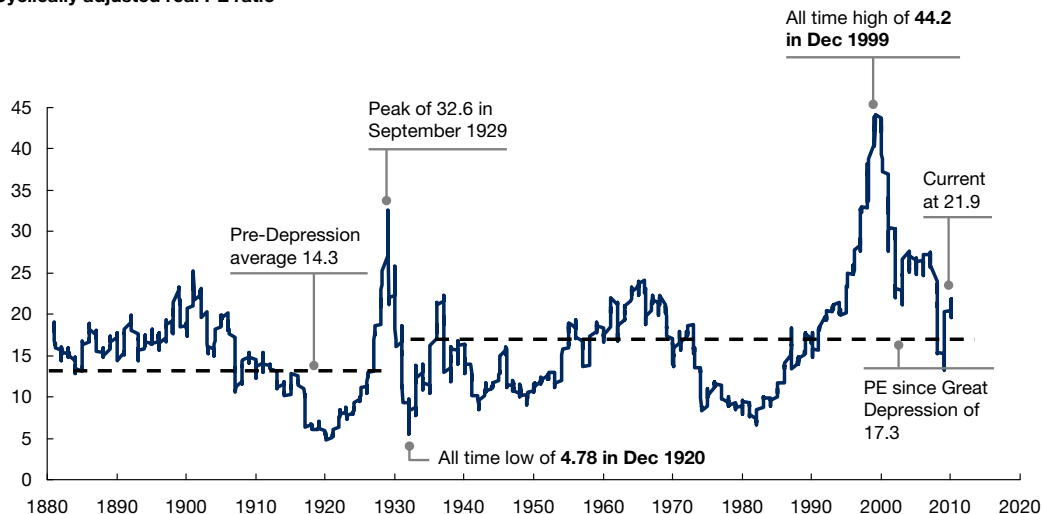
We nonetheless believe that all types of institutional investors should – within the limits of their fiduciary obligation – gradually shift and extend their investment horizon, leveraging one of the few competitive advantages they have in today’s markets.

The reasons for this shift are four-fold. First, almost invariably, this longer-term view will allow them to better align their investment strategies with their fundamental investment objectives and liabilities (where relevant). Second, an extended time horizon will allow an increased focus on long-term trends and fundamental value creation drivers versus short-term market movements. Third, longer holding periods allow institutional investors to capture illiquidity premiums embedded in less liquid asset classes, such as private equity, real estate, and infrastructure. Last, a longer-term perspective will also allow the development and implementation of “house views” on trends that can play out over many years, and avoid short term macroeconomic “noise.” For example, the longer-term perspective should allow institutional investors to take advantage of very long-term valuation cycles rather than focusing on short-term market swings. Putting current market levels into their long-term context can yield important investment insights and improve decision making. For example, putting equity prices into their long-term context, as through Robert Shiller’s 120-year view of long-term price to equity ratios, would have allowed investors in December of 1999 to realize that \$44 is a high price to pay for \$1 of earnings (Exhibit 4). These long-term convictions will allow investors to transform the risk of near-term uncertainty and volatility into an opportunity for superior returns.

However, extending the investment horizon is not easy for institutional investors. First, organizations dealing with multiple stakeholders and facing a higher level of public scrutiny, or semi-annual performance disclosure obligations, can find this shift particularly challenging. Second, creating the necessary conditions to adopt and maintain this perspective requires alignment of a large number of factors, including

EXHIBIT 4

Implementing an absolute return framework and mindset provides powerful perspectives and insights to decision-making

Cyclically adjusted real PE ratio¹

¹ Inflation adjusted monthly price vs. last 120 months real earnings for all companies in the S&P500

SOURCE: Robert Shiller; "Irrational exuberance"; McKinsey analysis

objectives, benchmarks, incentives, and culture. Third, institutions need to maintain and reconcile rigorous internal performance management systems for investment professionals (pay for performance, reward high performers, etc.) with these longer-term investment objectives.

Despite these challenges, some institutions have made significant progress in this transition. For example, some institutions have adjusted their benchmarks and related incentives to include horizons of 10 years or more, while others are developing concentrated very long-term equity portfolios. Furthermore, some institutions have decreased the frequency of investment professionals' performance evaluations to periods of 3 to 5 years, while one institution surveyed uses 20-year rolling average fund performance to drive the bulk of incentive calculations.

Interestingly, all institutions aiming to extend their investment horizon strongly believe in the need for top management support of the long-term perspective. Only when an institution's CEO and CIO have fully committed to a long-term perspective can there be hope to shift the mindset and culture among investment professionals.

3. Align benchmarks and incentives – measurement versus management

The appropriateness of benchmarks and related incentives is a long-standing debate among board, management and investment professionals. The tension lies in an institution's ability to use a benchmark as an appropriate assessment of relative performance, while avoiding a short-term relative mindset, which could ignore underlying asset long term fundamentals.

More specifically, in the case of public benchmarks, a number of potential constraints can arise with the use of benchmarks and a relative performance mindset. First, relative benchmark frameworks and frequent performance measurement can drive short-term investment behaviors that are not

“Benchmarks are creating the wrong incentives for our managers. We are considering all approaches, including moving to absolute return benchmarks, to make their focus on generating returns, not beating the index every week.”

– Head of asset allocation, Asian SWF

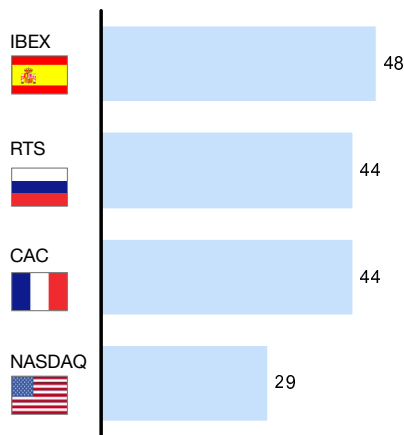
aligned with overall long-term investment objectives. Second, a benchmark approach can lead to unwanted investment exposures that are difficult to mitigate without overextending the active risk budget. For example, the Nasdaq benchmark currently includes a 20 percent exposure to Apple, and 3 companies currently represent 44 percent of the Russian RTS index (Exhibit 5). Last, such approaches limit the flexibility of the organization to pursue a full range of active management strategies, including relationship investing, and also inhibit the organization's ability to develop and implement long-term investment theses.

EXHIBIT 5

Index investing can lead to unwanted concentration in company exposures

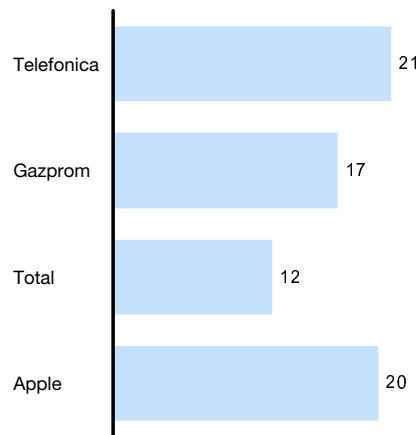
Weight of top 3 companies in index

Percent of total index by market cap



Weight of largest company in index

Percent of total index by market cap



SOURCE: Datastream; Data as at April 2011

Given these challenges, we believe that institutions need to review their benchmarks and incentives to ensure that they truly align the organization on its fundamental investment objectives, and adequately account for the risks inherent in different asset classes and investment activities. Furthermore, the benchmarks must allow the investment teams to implement investment strategies using a time horizon more in line with the objectives of the organization than traditional benchmarks allow. For most illiquid asset classes, this benchmark review will result in decisions to move them closer to absolute targets than relative ones. However, for liquid asset classes, we believe investments should be managed using absolute benchmarks, but measured using relative investable benchmarks over a long-term horizon, to capture the opportunity cost of the strategy.

The crux of the issue is how to develop an absolute return mindset within the institution, while recognizing and rewarding the difference between market returns and true value-added investment decisions. Institutional investors have a significantly evolved outlook on this issue and are making needed shifts to their benchmarks. First, many institutions are shifting to a variety of absolute benchmark approaches for illiquid asset classes, and are also launching absolute strategies within their public equity portfolios, with appropriate shifts in benchmarks. Second, institutions are re-aligning their incentive structures with this shift in objectives and benchmarks, in some cases decoupling performance measurement from incentive calculations.

Institutions are exploring a wide spectrum of options in shifting to absolute benchmarks. For instance, some institutions have developed a credit-rating-assessment approach for illiquid asset classes, each of

“Fighting the relative investment mindset is a constant battle. We need to both change our investment culture and rethink our portfolio construction.”

– CIO, large European institution

which implies a different real return objective. They use the underlying rigor of credit-rating assessments to improve decision-making and risk management in asset classes where VaR has significant limitations. A number of other institutions use a hybrid benchmark including a short-term performance component as well as a very long-term absolute return component, which is fund-based.

In terms of incentives, some institutions are decoupling their institutional performance measurement from individual performance evaluation and incentives. For example, many institutions are adapting benchmarks for incentive calculations in public equity strategies to reflect the underlying strategy. However, performance for the equity investment activities of the institution continues to be reported vs. easily investable benchmarks, such as traditional market indices.

The second issue regarding incentives, which was made particularly salient in the recent financial crisis, is that short-term annual incentives, whether based on relative or absolute performance, act as perpetual call options for investment professionals who act rationally when faced with these structures. Unfortunately, mitigating features such as clawbacks are a double-edged sword: in some cases professionals would do better to switch employers and start fresh rather than try to dig themselves out of their accumulated losses. Many institutions are seeking to address this tension in the process of re-aligning their incentives, including instituting both caps and floors for investment professionals' incentives, to help avoid that professionals either begin to engage in excessive risk-taking or leave the institution.

Rethinking investment strategies

4. Put the “strategic” back into asset allocation

The crises in 2001 and in 2008 have shown that traditional diversification fails when it is needed most. Leading institutions are already in the process of implementing adjustments to their asset allocation approach in order to address this critical shortcoming.

However, most institutional investors currently perform their strategic asset allocation using modern portfolio theory principles. The approach typically consists of building an optimal portfolio based on the historical performance of different asset classes and their expected correlation. Though this approach remains conceptually valid and relevant, we believe that it suffers from a number of critical flaws, which institutional investors cannot ignore. First, the choice of asset classes to use in strategic asset allocation varies by institution and can have a material impact on its strategy, returns, and on the effectiveness of its diversification approach. Deciding on what constitutes an asset class, and what level of granularity to employ is no easy task. Second, it is problematic for managers to estimate the future performance of each asset class based on its past performance. For example, in 1990, a manager looking at 10-year returns for Japanese equities would have seen total returns in the 24 percent range (with volatility of 22 percent.) The resulting increase in allocation to such equities would have led to disastrous results for the following 10 years, which showed returns of minus 6 percent (and volatility above 25 percent). We believe this unpredictability will be exacerbated, not improved, over the next decade. Third, portfolio theory relies on historical correlations between asset classes to provide diversification benefits throughout the economic cycle. This assumption has proved to be false over both crises in the last decade, and will likely continue to prove false in future crises. This vulnerability to extreme events will become increasingly important given our belief in the increased magnitude and frequency of these events. Interestingly, research on the subject has shown that a diversification by risk factors can be effective, even during crisis periods, with correlations among risk factors remaining low throughout turbulent cycles. Last, though the knowledge that correlations can increase dramatically during crises is now widespread, institutional investors need also be aware of the long-term shifts in correlations within the new investment landscape. For example, contrary to the beginning of the past decade, commodities have become increasingly correlated with market returns and energy prices, as well as with each other.

“We are slowly moving away from a pure relative environment to increase the share of absolute return management. It is a prerequisite for success.”

– CEO, Superannuation Fund

To respond to these challenges, institutional investors will need to enrich their current asset allocation approach in the following ways.

- By systematically reviewing their assumptions and core beliefs about all asset classes in terms of expected returns, volatility and correlation, to include house views on expected shifts in these risks return characteristics. For example, some institutions are adjusting the expected performance of private equity, given structural changes in regulations and in leverage availability.
- By taking into account extreme events in distribution of returns rather than focusing solely on traditional VaR methodologies.
- By adding a risk-factor lens to their portfolio allocation. Though we believe that it would be challenging for the majority of institutions to fully shift their allocation approach to a risk-factor allocation model, they should seek to diversify across risk factors by adding a “risk overlay” perspective to their traditional approach. In this way, they can continue to perform traditional strategic asset allocation activities, but with increased diversification protection during downturns. Institutions should thereby be able initially to maintain their traditional approach, while benefitting from a risk diversification mechanism to protect them during downturns. Over time, we believe that the notion of risk factors will become more prevalent in strategic asset allocation, to perform risk and performance attribution analysis – once institutions have better defined their risk appetite and strategy, and once they have developed the risk management tools and capabilities.

We also believe that strategic asset allocation monitoring and decisions should be made on a gross basis (i.e., including all leverage positions) to ensure that it is truly aligned with the risk appetite and desired expected performance of the organization.

5. Develop innovative public equities strategies

Public equities generally comprise between 30 and 50 percent of the asset allocation of large institutional investors. Given the relative risk vs. fixed income of public equities, they usually drive the bulk of investment returns, positively or negatively.

Over the past 10 years, many large institutions have shifted from external to more cost-effective internal management of public equities, with a large allocation to passive management, usually including a significant home country (or home region) bias. Among active strategies, a relative performance mindset and short-term orientation has continued to hinder superior performance across the industry.

Looking ahead, institutions are uneasy about the potential prospects of passive public equity management strategies, and are unsure on where to place these bets at the global level. Instead, many institutions are developing a wide variety of new public equity investment strategies, with the mindset of increasing alpha returns to reduce their dependence on overall market movements. Three such strategies stand out: long-term relationship investing, thematic investing, and “all-weather” strategies.

Long-term relationship investing

Most institutional investors currently construct their portfolio by holding most of the underlying securities included in their benchmarks, and making active bets by under-weighting or over-weighting certain sectors or securities. They typically hold hundreds if not thousands of securities, and they understand the fundamentals of these in a limited way (at best).

Taking into account the expected changes to the investment landscape we have described, and the necessity to extend their investment horizon, some investors with internal active management capabilities are revisiting how they construct their liquid portfolios. They are building portfolios with fewer securities,

(diversification benefits typically become marginal after 50-60 securities over a 3-year period), larger individual positions, and longer holding periods.

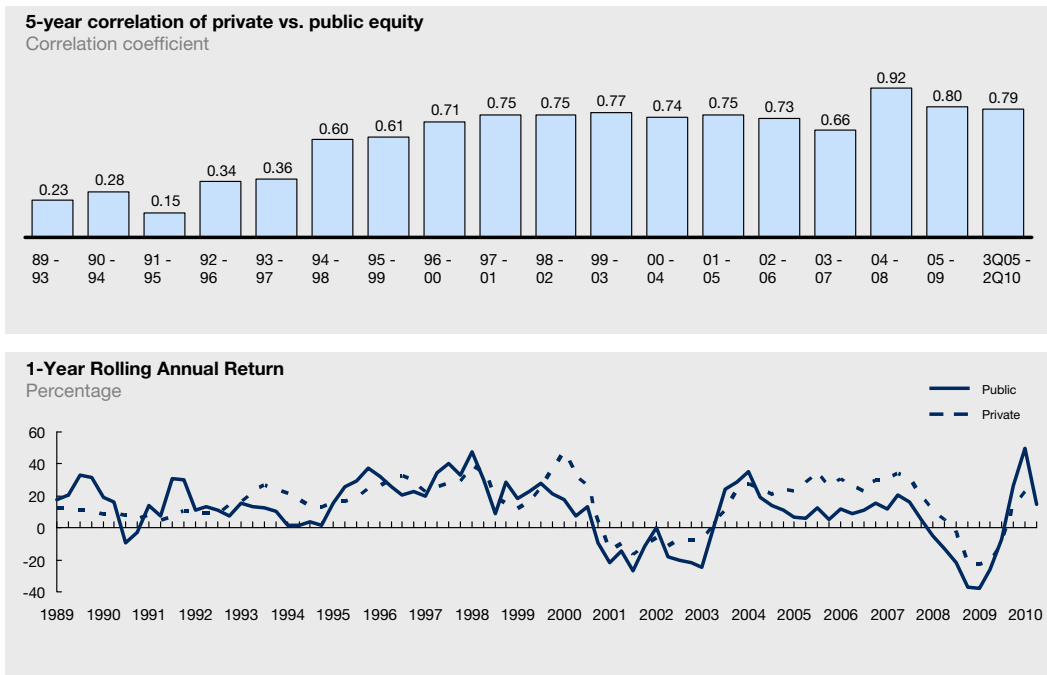
We believe that the main value in relationship strategies stems not from active ownership or explicit value add, since institutions still maintain minority stakes, but from the fact that this approach allows the organization to spend more time understanding the value drivers of the companies it invests in.

In the active management of public equities, investors are also realizing that a private equity mindset can be very appropriate for long term active management of public equities. Some institutions are creating dedicated portfolios of concentrated long-biased positions and at times transferring key talent from other teams such as private equity to manage and support these portfolios.

Indeed, many institutions have realized the increasing correlation between private and public equity returns, particularly in developed markets, some going so far as to combine these groups from an organizational perspective (Exhibit 6).

EXHIBIT 6

The correlation of returns between public and private equity has increased



SOURCE: Cambridge Associates, Bloomberg, McKinsey analysis

Thematic investing

Given the expected changes in the market landscape, many institutions believe that investment opportunities will be clustered around underlying trends or themes. They have started to identify investment themes that they believe will generate attractive investment opportunities over the coming years and that are in line with their existing capabilities. Some institutions are looking at these themes with an equity lens only, while others are taking a cross-asset-class perspective. To be successful in tackling these opportunities, investors once again will need to adopt a longer-term investment horizon and an absolute return mindset.

It is noteworthy that some institutions have decided to tackle these themes by investing both with internal teams as well as with specialized external managers sharing similar market convictions and complementing internal expertise.

In developing and implementing thematic views, we believe the key challenge will be organizational and not strategic. To be successful, institutions need to be able to better coordinate their research efforts with their investment groups, as well as develop governance mechanisms that balance appropriate oversight with autonomy and accountability for investment decisions.

“All-weather” strategies

Many institutions are developing approaches to build an “all-weather” portfolio. In some cases, this has meant centralizing active management investment decisions on a limited number of equity strategies. These strategies (e.g., a global-value portfolio) are then translated into a set of specific parameters for investment professionals, who then have discretion to execute the strategy within the pool of stocks that fall within them (debt levels, stability of cash flow, stability of earnings, etc.). In some cases, this type of approach has increased relative risk by a factor of 10, from 100 basis points to 1,000 basis points, though absolute risk typically decreases considerably, given the nature of the selected stocks.

Other institutions are using the risk factor overlay in their strategic allocation approach, as described above, to develop portfolios that meet investment objectives under various economic scenarios.

6. Increase allocation but also value-add in alternatives

The rumors of the death of alternative assets have been greatly exaggerated. Just 2 years after the financial crisis, long-term performance remains strong in private equity and hedge funds and fund-raising activity has returned more quickly than anticipated. Accessibility has also increased, and real estate and infrastructure fundraising have begun to eclipse buyouts.

A shakeout has nonetheless begun in the industry, with two classes of winners already evident: (i) large global multi-asset class managers, and (ii) specialist firms with a tight sectoral or geographic focus. The largest firms are already finding it difficult to achieve top returns at scale, but offer the benefit of being able to deploy large amounts of capital. Specialist firms, on the other hand, aim at outstanding returns, but do not have the capacity to achieve these results at scale.

“Most LPs pick based on past performance, which used to make sense since there was persistence of returns, but that is changing and by the next cycle will probably not hold.”

– CEO, large US private equity group

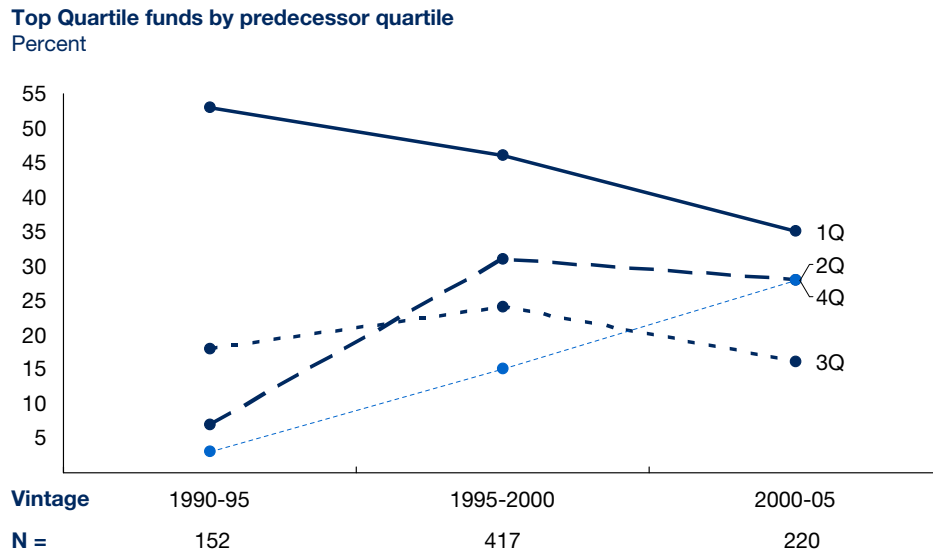
For institutional investors, picking tomorrow’s winners is more difficult than ever before. First, significant changes in the regulatory framework and in leverage availability will create challenges for the entire industry. Second, in private equity and hedge funds, persistence of returns may have diminished, making past performance a less reliable indicator of future performance than in the past (Exhibit 7). Last, more value will be generated by performance improvements than financial engineering, a dynamic that has profound implications on how LPs should deploy capital within this asset class.

The industry changes taking place in most of the alternative asset classes will have significant implications for how institutional investors deploy capital on that side of their portfolio.

- **Institutional investors deploying capital through third-parties** are accelerating the review of their portfolio of external partners to limit the number of managers (at least in developed markets), while deepening their relationships with these managers. In order to do these things, leading institutions will undertake the following activities.
 - Begin to increase their sophistication and foresight at assessing the ability of funds to generate continued superior returns. They will do this by understanding GPs’ ability to add value to their

EXHIBIT 7

The persistence of returns in private equity has declined; top returns now less reliably suggest future outperformance



SOURCE: Private Equity Intelligence Ltd. 2011; McKinsey analysis

portfolio companies, or by linking “house views” on investment opportunities with the stated strategies of external managers.

- Deepen their relationships with their preferred managers, into value added partnerships, typically resulting in more numerous co-investment opportunities.
 - Modify their criteria for emerging markets to include promising first-time managers, that are focused in desired geographic/sector combinations.
- **Institutions making direct investments** in alternatives will need clearly to identify areas where they have the appropriate knowledge and insights to deliver superior returns, and avoid sector or geographic overconcentration over time. They will also have to build the right sets of capabilities to compete with other market participants, which in a public or quasi-public environment might prove to be highly challenging. In private equity, for example, this will mean complementing teams of deal makers with industry specialists, former business operators and functional experts. In infrastructure, teams will need to combine the right mix of financial expertise and deep asset operations knowledge, not to mention local connections and networks

7. Avoid the “free lunch” mirage of emerging markets

Global institutional investors are almost without exception increasing their focus and allocations to emerging markets, and are planning to continue this trend. Among the institutions surveyed, allocations to emerging markets have increased by a factor of three over the past 5 years.

However, most institutions agree that the emerging markets free lunch is over, and a passive “me too” approach to investing in these markets is bound to lead to disappointing results. The valuation gap has mostly closed with developed markets, and economic growth is no guarantee of investment returns in these markets. Astute investors will spend a lot of time and effort evaluating asset prices in these markets against their investable alternatives in developed markets – due diligence needs to be *more* rigorous,

not less, in this environment. Furthermore, correlations between emerging and developed market equity returns have also increased significantly, further reducing the attractiveness of a purely passive exposure.

Despite the risks inherent in passive emerging market exposure, significant active opportunities are available to the thoughtful investor willing to invest appropriate resources and capabilities to their identification and capture. Many institutions are increasing allocations to active strategies in emerging markets, both in liquid and in illiquid asset classes.

The debate is not about whether emerging markets will yield attractive opportunities, but rather about how best to position the institution to capture these opportunities. There are four main aspects to this debate:

- **First**, institutional investors building their emerging-market strategy need to think about the governance structure they will put in place to prioritize, approve, and monitor emerging market investments. The main debate on governance involves how much to centralize and coordinate efforts – what decisions need to be top-down vs. bottom-up. Some institutions simply adjust targets and limits for their investment groups within emerging markets, and allow their professionals to identify and evaluate investment opportunities individually. Others take a more centralized approach, developing a prioritized list of countries (and sometimes sectors as well), and deploying country teams and sector teams to develop and capture opportunities. One institution insisted on having both country and sector teams sign off on every relevant investment, in both public and private transactions.
- **Second**, these same institutions generally disagree as to the importance of local partnerships. On the one hand, institutions that discount the importance of local partners do so because they believe that relationships with international partners that have existing operations and connections in the target geography suffice, and/or they focus on public equity investments where such connections are less important. On the other hand, other institutions believe that local partnerships are the only way to access attractive deal flow and to properly assess and manage the idiosyncratic risks inherent to these markets. This second group of institutions typically invests in a limited number of platforms, in order to build capabilities and relationships at scale. These platforms may not appear justified in the near term, due to insufficient attractive deal flow and opportunities, but institutions implementing this strategy are betting on their long-term potential.
- **Third**, internal versus external management is another area for debate. Some institutions focus on internal management within most asset classes, including actively managed public equities, real estate, and infrastructure. These institutions believe that they can develop or hire the appropriate capabilities in house and that there will be a sufficient volume of opportunities to justify the investment. This choice also implies a clear prioritization of asset class/country combinations, since it is not possible to develop capabilities in all markets simultaneously. Other institutions focus on selecting external managers, particularly for public and private equity. One inherent challenge in this activity is the absence of long-term track records for most managers – some institutions in fact target first-time funds with promising managers from firms they respect, believing in their ability to convert an existing process to a new market. On the other hand, institutions that are internalizing most management are having to deal with important governance and organizational challenges with managing an in-house team of investment professionals.
- **Last**, different institutions evaluate the importance of a local footprint differently when investing in emerging markets. Some institutions are investing heavily in local offices and capabilities, while others believe in the “road warrior” approach, aiming to generate sufficient deal flow and activity to build reputation and market knowledge.

Evolving organizational enablers

8. Rethink governance structure, capabilities, and decision rights

The events of the last decade have motivated institutional investors to take a fresh look at their governance model to ensure it is providing the right balance of oversight and agility for the organization. More specifically, three events have caused institutional investors to start re-thinking their governance model:

- **Increasing size and complexity.** Over the last decade, many institutional investors dramatically grew in terms of headcount and organizational complexity. For example, one “new” institutional investor went from literally no employees in 2000 to over 600 by 2010. Another institutional investor grew the headcount of its middle and back office by 5X over the same period. In addition, institutional investors increased the complexity of their organizations – new offices, new asset classes, more internal and active management, more complex middle and back office functions. This has caused institutional investors to question whether their governance model needs to evolve to keep pace with the tremendous change in organizational growth and complexity.
- **Global financial crisis.** Many of the challenges faced by institutional investors during the financial crisis can be traced back to governance issues. For example, were boards knowledgeable enough to adequately oversee the risks being assumed by new complex instruments? Were the roles and responsibilities between sponsors, board members and management clear and transparent enough to allow for adequate accountability? Did decision rights and governance processes allow for a rapid and appropriate response to the crisis as it unfolded? Clearly, the crisis has triggered renewed attention and focus on institutional investor governance.
- **Cultural challenges.** As many institutional investors continue to internalize the active management of assets, many have begun to face significant cultural challenges. More specifically, successfully managing investment professionals in the alternatives space has become the epicenter for a number of issues. These have ranged from high profile debates around executive compensation, to the ability of boards to provide effective oversight, and to more “operational” issues in the middle- and back-office functions. The persistency of these issues and the amount of organizational bandwidth consumed has caused many institutional investors to question their existing models.

In response to these challenges, organizations have begun to explore alternative governance models. Some organizations have initiated broad based governance reviews that include sponsors and management to evaluate more radical governance solutions while others have adopted a more incremental approach.

In particular, institutions seeking to improve the effectiveness of the current governance model are focusing their efforts in three specific areas

- **Clarifying the roles, responsibilities and decision rights between sponsors, board members and management.** Institutions are becoming much more granular in their definitions of what requires board approval versus what can be approved by senior management. Institutions are also clarifying the fiduciary responsibilities assumed by board members and using this to guide the roles and responsibilities analysis. We believe that all institutions should develop detailed reviews of their decision rights framework, with a focus on investment and risk management decisions. A formal approach, such as the RACI framework (Recommend, Approve, Consult and Inform) is extremely helpful not only in clarifying roles and responsibilities, but also in allowing for a debate and review of these decision rights (Exhibit 8).

EXHIBIT 8

Example decision right framework

R: Recommend C: Consent
A: Approve I: Inform

DISGUISED EXAMPLE

Investment decisions	Fin. Comm.	CEO	Inv. Comm.	VP Inv.	Head of Fund	Asset Class trader	Risk Comm.	VP Risk
A Investment philosophy and asset allocation								
▪ Definition of mission / objective of investments	A	C	R	I			I	I
▪ Definition of investment philosophy	A	C	R	I			I	I
▪ Definition and modification of SAA								
– Definition of SAA	A	C	R	I	I	I	C	I
– Modification of SAA	A	C	R	I	I	I	C	I
▪ Definition of the investment strategy per asset class								
– Selection of Active vs. Passive approach	A	C	R	I	I	I	I	I
– Selection of internal vs. external management								
B Portfolio management								
▪ Approval and execution of TAA moves								
– Approval of TAA boundaries	A	C	R	C	C	I	C	I
– Execution of TAA moves				C	A	I	I	I
▪ External Manager selection, allocation and termination								
– Screening and selection of manager		C	A	R	I	I	C	I
– Change in mandate of external manager		C	A	R	I	I	I	I
– Termination of relationship		C	A	R	I	I	I	I
▪ Security selection								
– Security selection for beta portfolio				C	I	A	I	I
– Security selection for alpha portfolios				C	I	A	I	I
▪ Definition of hedging position			R	A	I	I	R	I

SOURCE: McKinsey analysis

- **Significantly improving board member education.** Institutions are designing comprehensive training and capability building programs for directors. These programs are designed to help directors (specifically new directors) ask the right questions of management and learn where to focus their time in board sessions.
- **Creating a more robust advisor management process.** Advisors continue to play a critical role for boards. However, institutions are taking a fresh look at their advisor management processes to ensure they are selecting the best advisors available and are managing them accordingly. For example, one institutional investor has rolled out mandatory RFPs for advisors every 3 to 5 years and are cross-checking the advice received to ensure they are getting the quality of advice they need to fulfill their fiduciary obligations.

Some institutions believe that the above approaches insufficiently address their key issues and are exploring more profound structural changes. We see two such changes among institutions.

- **Modifying director selection criteria.** Some institutions have begun to work with sponsors to change the types of individuals recruited on to boards. Specifically, they are focusing on more professionals and specialists who can bring outside knowledge and capabilities to enhance overall board effectiveness (e.g., knowledge of compensation practices in private equity). Some institutions are seeking to maintain a “lay majority” while others are seeking to dramatically overhaul the board and move to a “professional/specialist” majority.
- **Changing the organizational structure.** Some institutions are now actively considering alternative organizational structures to address the governance challenges cited above. For example, one North American institutional investor is working on a “spin-out” of its entire investment division into a new entity with a new sponsorship structure. Another North American institutional investor is exploring creating a wholly owned subsidiary which would be governed by a new professional board.

9. Align risk management to evolution in strategies

Implementing the changes to investment strategies described above will have significant ramifications for risk management by institutional investors. After the financial crisis, many institutions invested heavily in developing and implementing sound risk management practices¹ and we believe that the coming years will bring risk management into a new era (Exhibit 9).

EXHIBIT 9

Risk management needs to evolve to become more of a forward-looking thought partner to investment teams

	"Pre-crisis"	"Post-crisis"	"Tomorrow"
Measuring risk	<ul style="list-style-type: none"> Emphasis on VaR for liquid asset classes, with limited understanding of total fund exposure More emphasis on relative risk than absolute risk Lack of stress-testing capabilities (often limited to single factor sensitivity) 	<ul style="list-style-type: none"> Refined VaR methodology for liquids and "patches" used to assess risk exposures in illiquids Slightly increased focus on absolute risk More robust and systematic stress-testing practice (multi-factors) 	<ul style="list-style-type: none"> Customized risk measurement and management for illiquids, focused on underlying value drivers Absolute risk slowly becoming the key measure Stress-testing as an integral part of the risk management framework
Adding value	<ul style="list-style-type: none"> Risk management group focused on measuring, not managing Very limited dialogue between risk management and investment professionals 	<ul style="list-style-type: none"> Risk management group playing a more active role, going beyond measuring (e.g., participating in TAA decisions) New committees and change to foster exchanges within risk and investment groups 	<ul style="list-style-type: none"> CRO acting/positioned as a peer to CIO Risk management group as investment thought partners Dedicated emerging risk team and processes, in collaboration with research

SOURCE: McKinsey's 2011 Institutional Investor Benchmarking Initiative

The current environment and shifts in strategy will require that investors consider making three additional fundamental changes to their current risk management framework.

- First**, the role of the risk management group should be revised to ensure that its mandate goes beyond its traditional control function to become a value-added thought partner to the investment function, to research, and to the board. Risk management should be working in close collaboration with the investment professionals to bring insights both about the risk-return potential of the portfolios and implications of changing market conditions on the performance of the portfolios, and on appropriate pricing of risks in investments under consideration. To do so, institutions need to find ways to foster a constant dialog among investment and risk professionals and establish a true culture of collaboration.
- Second**, institutions relying solely on relative VaR methodologies to monitor their overall risk exposure will need to make considerable adjustments to their practices. While the VaR approach has multiple advantages, including the ability to report a single number, it also incorporates a number of limitations. Future volatility, for example, will be inconsistent with historical levels for most asset classes; there will also be greater proportions of illiquid investments and longer holding periods in equity portfolios. As a result, institutional investors will need to implement two radical changes.

 - **Institutions will need to shift their mindset from relative to absolute risk management.** While the former should still be measured and monitored, we believe that greater attention should

¹ A summary of these practices is provided in "After Black Swans and Red Ink: How Institutional Investors Should Rethink Their Risk Management Practices," (McKinsey & Company, 2010).

be granted to the latter in the management of risks. Risk management groups are responsible first and foremost for avoiding permanent capital loss, not index underperformance. This shift needs to be translated into new metrics and limits to monitor and control risks. Absolute VaR, measured vs. a baseline of zero, rather than the index, is one step in the right direction, but it is not sufficient. In some cases, an increase in absolute VaR may breach risk limits though the underlying investment thesis and fundamentals remain sound.

- **More “business-oriented” metrics need to be employed in asset monitoring**, given the shift to a more “absolute” investment framework, and increased allocations to real assets. While metrics will vary by asset class and strategy, they should be linked to the underlying economic value drivers of the assets. In many cases, these metrics will be quite similar to those assessed in the diligence phase of investment. Adopting such an approach will not only improve the institution’s ability to truly understand its risk exposure, but will also facilitate the dialogue between risk and investment professionals as they will now be “speaking the same language”
- **Third**, institutional investors need to increase their ability to anticipate extreme events that can wipe out years of positive returns and understand their implications across asset classes, particularly as traditional sources of insurance are prohibitively expensive at present. Institutions should therefore develop emerging risk identification processes allowing them to increase their chances of detecting extreme events and take appropriate action. We believe that at a minimum institutions need to increase their organizational awareness of extreme events, include the impact of these potential event in their investment and risk management frameworks and develop specific risk mitigation plans in case of their materialization. Exemplary measures would be accelerated decision making processes or pre-determined triggering factors for use of stop losses. Another measure that institutions can take in the short term is to increase the coordination of efforts between their risk management group and their strategic asset allocation (discussed under heading 4 above, “Put the ‘strategic’ back into asset allocation”). To increase coordination in these two areas, the institution will also need to increase coordination and collaboration between its research function and the risk management group. In too many organizations, these groups are operating in silos, while they should be continually complementing and challenging each other’s views.

10. Develop research as a strategic priority

Delivering superior performance in the “new normal” will require institutional investors to develop better perspectives about the evolution of macro-economic scenarios and long-term trends as well as specific “house views” on different investment themes. Most institutional investors will accordingly need to invest more in proprietary research, but to derive full impact from this investment, institutions will need to focus on five success factors.

- **First**, the research function needs to be positioned as a top strategic priority for the organization and be headed by a thought leader, generally reporting to the CIO or CEO. Institutions need to improve proprietary research capabilities not by hiring a large number of Ph.D.s or experts, but rather by trying to attract a limited number of true thought leaders from diverse backgrounds who can develop original hypotheses, going beyond market consensus, and drive strategic discussions. More specifically, we see relatively little value in having a research group focusing on synthesizing available sell-side research, without the thought leadership and capabilities to develop unique house views.
- **Second**, a number of processes need to be put in place to ensure that: (i) the research teams focus their efforts on matters that are truly relevant for investment and risk professionals, as opposed to more “academic” matters; (ii) that research findings are appropriately shared and debated across the organization and (iii) that the research becomes an integral part of the investment process. To respond to these objectives, some organizations have created a research team composed of members from different investment groups, that is responsible for developing and maintaining the research agenda for the entire organization. The members of this team also act as a conduit to their respective groups

for knowledge-sharing purposes. Other organizations hold annual or semi-annual events during which key themes on the research agenda get presented and debated among senior executives, laying the foundations for TAA decisions and other important adjustments to the investment strategy.

- **Third**, institutions should determine the level of centralization that they need in their research function. For instance, central research capability can be built as a shared utility to support the different investment teams in developing specific market insights. This central team could also be responsible for developing mid-term perspectives for the different industries to which the portfolios are exposed and provide a different perspective to the portfolio managers who are usually taking a shorter view of the market. The goal is obviously not to replace the research performed within the investment teams, but rather to complement it with an independent and dedicated team having more resources and solely focused on delivering investment insights. In any case, investment professionals will have to be heavily involved in the design of the research agenda of this team to make sure that the output will truly be relevant to their needs and will have direct impact on their investment activities.
- **Fourth**, given their size compared to other market participants, institutional investors cannot aspire to develop all their knowledge internally and successfully compete on the markets. Leading institutions have consequently begun developing strategic and more exclusive partnerships with different types of external players, including banks, asset managers, consultants, academics, and think tanks. These partners provide access to customized research responding to institutions' specific needs. With such an approach, institutions complement their internal capabilities and selectively pick the players best suited to respond to their specific needs. Many players are responding to this emerging demand from institutional investors by creating dedicated teams focusing solely on their requests and we believe that this model will rapidly gain in popularity in the coming years.
- **Last**, institutions should increase their knowledge management capabilities in order to codify, share and actively manage the research they develop or they buy from external vendors. Institutions will need to create opportunities to break investment silos and development hassle-free knowledge-sharing platforms and tools.

11. Refine the role and reach of the center

In delivering on their strategy, institutions must first and foremost clearly deliver on the role of the center, which includes two key activities: a) aligning the institution around a shared investment philosophy, and b) managing both liquidity and leverage.

Investment philosophy

Very few institutional investors can articulate an explicit investment philosophy that is widely shared across the organization and truly governs strategic thinking around investment decisions. In our previous institutional investment white paper, "The Best Practices and Next Practices of Institutional Investors," we expressed the view that investors need to develop and codify a series of core investment beliefs, which collectively form an investment philosophy, and govern the investment strategy of the different parts of the organization.

The philosophy can comprise a series of financial and asset management topics, but we believe particular emphasis will need to be put on three areas. First is the translation of the organization's risk appetite into concrete investment guidelines, going beyond policies and limits; second, the philosophy must define the investment horizon and its implications on investment targets, portfolio construction and tolerance to volatility, and third, it should articulate the institution's belief about potential sources of market outperformance. Clarity in these three areas, and alignment of the investment teams around the approach, will be critically important in achieving results. Ensuring that these principles are appropriately cascaded down into the investment strategies of the different investment teams will be a bit more challenging. But

more critically, these core beliefs will need to become the institution's "charter," against which important investment decisions should be assessed when divergent points of view arise among senior leaders, and particularly in times of market turbulence, when short-termism tends to become more prominent.

Liquidity and leverage management

With greater exposure to illiquid asset classes and derivative products (either for hedging purposes or active strategies), proactive management of both liquidity and leverage will become increasingly important for institutional investors. The increasing complexity of the instruments used, strategies deployed and the correlation and potential interconnectedness of the portfolios (e.g., when an uncapitalized portfolio is financed by repos of another portfolio) demand a central liquidity and leverage function headed by someone who is fully accountable for the overall liquidity situation of the fund, as well as its level of debt. In collaboration with the investment professionals and the risk management group, this person should develop and maintain a liquidity plan to ensure optimal liquidity levels by both limiting the chances of potential liquidity crunches and by not carrying excessive liquidity when market conditions evolve favorably.

Similarly, leverage should also be managed by a single point person (rather than in each asset class) in order to ensure a deep understanding of the holistic leverage situation of the organization. In so doing, the institution should be able to better manage their tenor and currency exposure, and therefore make more optimal use of leverage to increase returns, while managing risk adequately.

12. Build a global ecosystem of value-added partners

Over the past decade, many institutions have begun to realize the value of developing a global ecosystem of long-term partners. Indeed, many of the strategies described above will be far more likely to succeed if accompanied by relevant and value-added partnerships, including emerging market investment strategies, future alternative investing approaches, and others.

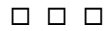
However, with the exception of a small number of industry leaders, most institutions have remained focused on "client-provider" and "co-investor" types of relationships, rather than developing more innovative and deeper relationships in investing activities, research, and risk management. Furthermore, leading institutions can cast a broader net in thinking about potential partners, including not just other institutions and managers, but also conglomerates, industry players, think tanks, consulting firms and networks of academics.

In order to succeed, institutions will need to be thoughtful in thinking through how they develop and maintain this ecosystem of partners over time. First, they will need to address three key success factors in partner selection:

- **Alignment of interests.** First and foremost, institutions need to seek out partners with aligned interests to their own. This can include a long term investment horizon, similar investment objectives, and similar risk tolerance. For example, a number of institutions are seeking increased exposure to agricultural land due to shared convictions on prospects for the asset class and due to their liability profile, but they do not individually have sufficient scale to develop a well-diversified international portfolio, so they are exploring an investment consortium approach in this area.
- **Complementarity.** Institutions need to develop networks with a small number of partners that are truly relevant to their strategy, and to which they can add value. For example, some leading institutions with emerging market real estate strategies rely on a limited number of local partners and developers for deal flow, due diligence, deal execution and monitoring. For these partnerships to be effective, institutions must be very aware of the value they are adding to the partnership beyond capital, including operating expertise, access to deal flow in other geographies, networks, and other factors.

- **Cultural and operational fit.** Often overlooked, institutions need to be acutely aware of the importance of cultural fit in developing effective partnerships. Partnerships usually involve a long term perspective. For example, even a simple co-investment in a long-life, illiquid asset could tie partners together for as long as 10 years or more. True partnerships require working closely together over time through multiple interactions at many levels of the organization. They require a relationship of mutual trust, and the ability to resolve conflicts that will inevitably arise. Despite the best intentions, a partnership between two institutions with conflicting cultures is bound to lead to significant management frustration and poor results.

Beyond selecting partners, leading institutions are improving their ability to coordinate and leverage these partnerships on a broader scale throughout the organization. At the leading edge, this can include designating a “partnership tsar” within the institution, responsible for tracking and maintaining a clear view on the entire portfolio of relationships and proactively making connections with different areas in the organization when appropriate. This coordination is increasingly important as large institutions have a wide reach of relationships, with varying levels of depth, and different areas of the organization are often left unaware of the entire ecosystem of partners available to them.



The coming decade is sure to present complex and unforeseen challenges for senior executives of investment institutions. In facing them, investment leaders will find themselves questioning the key elements of their historical investment strategies. Success will come from the courage to recognize the right path for the organization in the new environment, and the wisdom to influence and manage key stakeholders to collaborate fully on the needed transformation.

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