

Private Equity & Principal Investors Practice

Institutional investing in the time of COVID-19

Tested by the pandemic, many of the world's leading institutional investors are demonstrating resilience and agility.

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The humanitarian, social, and fiscal challenges

wrought by COVID-19—and those still to come—are historically severe. The economic harm to businesses and investors mounts daily. And it is difficult, within the eye of the storm, to ascertain the full extent of the damage.

Yet an early perspective from leading institutional investors (IIs) suggests that as destructive as the pandemic has been to their portfolios, it could have been a lot worse. After a decade-long bull run across asset classes, many investors already considered a “correction of some sort” as inevitable and had positioned their portfolios defensively. The result is that, by and large, many pension funds, sovereign-wealth funds, endowments, and other IIs have found themselves better off than they were in the 2008–09 global financial crisis. Across the industry, there is less of a sense of panic, greater investment discipline, and more continuity than there was in 2008.

We spoke with CEOs, CIOs, and other senior executives at 21 of the world’s leading investment institutions, including some of the most influential pension funds, sovereign-wealth funds, and endowments. These institutions, which manage \$3.7 trillion in assets across Asia, Europe, the Middle East, and North America, include some of the world’s more sophisticated public investment funds. We asked them for their reflections on the pandemic, how their crisis playbooks are holding up, and what this discontinuity may mean for long-term strategy.

Hard work after the last crisis is paying off

No institutional investor will emerge unscathed from the COVID-19 pandemic. Still, although the crisis may have a long way to go, the pandemic came late in the market cycle, so many investors had already begun to shift asset allocations to prioritize greater liquidity in anticipation of a correction. Indeed, most investors we spoke with felt much better prepared for this crisis than for the previous downturn. Most of the institutions we interviewed have been following some version of a similar three-part playbook.

- First, *maintain stakeholder trust*, including the trust of board members, beneficiaries, employees, and others. Top priorities include the health and safety of employees; financial liquidity; business continuity, such as work-from-home models; and investment performance. In some cases, institutions had already discussed with their boards how to act in the next crisis. As one chief investment officer of a North American pension fund told us, “I was explaining to my board our rebalancing process and what we would be doing, at which thresholds. They stopped me and said, ‘why are you telling us all this again? We know the plan. And we trust you. Let’s get on with it.’” At the same time, some institutions have faced a liquidity crunch; two we spoke with had worked through it in about two weeks.
- Then, *defuse portfolio risks*. Beyond the initial hit in the public markets, many investors have been continuing to wait—and wait and wait—for the other shoe to drop. While they wonder when financial markets may reflect real-economy impacts, they have been looking across their portfolios for areas that need immediate action. Naturally, the sectors most affected by COVID-19 have been a key area of focus not just for near-term impact but also for the uncertain future facing some of these industries. Illiquid asset classes, whose valuations typically lag behind in public markets, have been a source of concern—in particular, real-estate portfolios. As one leader told us, “I’m worried about our commercial real-estate portfolio, especially offices, given work from home... what is the ‘next normal’ going to look like?”
- Finally, *be alive to possibilities*. Many investors we spoke with still consider the markets overvalued. One endowment’s chief investment officer said, “we feel that the markets remain 30 to 50 percent overvalued.” Tellingly, only a few of these institutional investors were actively looking to take immediate advantage of dislocations. Most expressed caution and a need to be thoughtful about the path forward. Still, nearly all acknowledged that periods such

as these typically lead to some outstanding investment possibilities for those with the liquidity and the stomach to capture them. “The best investments that I have made in my lifetime have generally come down to two words: ‘forced sellers,’” said the head of portfolio construction at a leading North American pension fund.

Though the playbook is similar across institutions, some have clearly fared better than others. That’s probably a result of operational effectiveness; the crisis has served as a litmus test of how well different functions across organizations have been working.

Emerging lessons from the crisis

While it’s early innings, some practices appear more often and more prominently at leading institutions.

Stick with it

Pivoting strategy in reaction to market cycles typically hurts performance. A decade ago, many investors were burned repeatedly, especially (but not only) in private markets: deploying capital at the peak, selling at a discount, then sitting on the sidelines during the recovery. Many investors and their boards have said they plan to act differently this time. Those we spoke with are focused on parsing the crisis to distinguish temporary shifts from structural market changes and on maintaining (or even accelerating) their strategic momentum. As always, some investors have shown more resolve than others and today have deeper pockets ready to deploy. Others have just barely avoided a full-blown liquidity crisis.

Leaders of these institutions underscore the importance of holding on to high-quality assets as markdowns occur and portfolios begin to exceed policy allocations—even if this strategy means raising debt. “De-risking at the bottom of the market would be the biggest shame we could bring upon ourselves,” claimed one investment leader. Others agree but caution that this approach is not easy to execute: “Everyone can nod their heads, but when you are in it and feeling it, convictions begin to slip.”

Some institutions entered the pandemic already wounded. Among public pension funds, for example, the gap in resources between leaders and laggards has widened considerably. Many faced huge funding deficits before the crisis; if markets continue to fall, such gaps will probably widen further as these funds are forced to liquidate investments to pay beneficiaries or as contributions falter. Especially given volatile oil prices, some sovereign-wealth funds may see their portfolios tapped by governments to support competing economic priorities. “We are already facing looming fund draws,” commented one sovereign-investment leader. Said another: “our challenge now is as much balancing political pressure to provide loans to certain companies as it is defending our investment portfolio.” The playing field for institutional investors is not even, and the crisis may highlight and widen those disparities.

Walk the walk on ESG commitments

Environmental, social, and governance (ESG) factors (including diversity and inclusion) are very much on the minds of institutional leaders. In the weeks

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before the crisis, we surveyed the world's leading institutional investors about their commitment to ESG factors. Seventy percent said they would fully integrate ESG considerations across all of their investment processes (Exhibit 1).

In the midst of the pandemic, some of these institutions have doubled down on ESG, believing that it is even more important in troubled times. Such fund leaders have indicated plans to maintain or accelerate their ESG plans through the crisis. If this trend takes root, it would be a departure from precedent. During the 2008–09 global financial crisis, many investors deprioritized ESG to focus on solvency. The recovery that followed proved highly carbon intensive. The coronavirus pandemic represents a visceral reminder to investors and their boards of ESG's role in portfolio management.

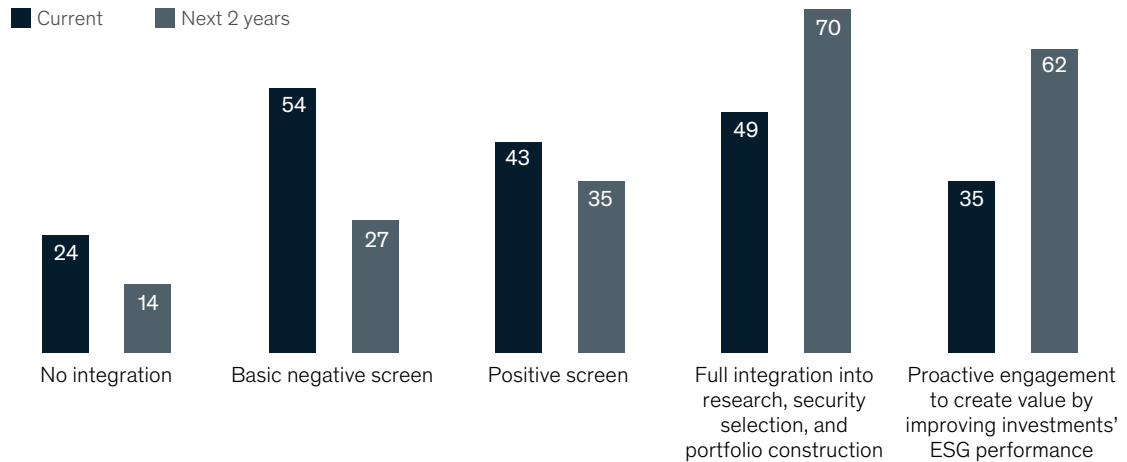
Evolve stress tests

There is wide variability in how surprised our interviewees have been by the pandemic's impact. Some described it as a true “black swan” event, far beyond any scenarios they had modeled or considered: “This was beyond our 99 percent value-at-risk (VaR) scenario by a large margin. We had two strategies, in particular, that did not perform the way we thought they would.” Yet others say a global pandemic was in many ways entirely predictable and had already stress-tested their portfolios for this type of eventuality, forecasting a possible market downturn as severe as what we have so far experienced. “This actually didn't even hit our 95 percent VaR threshold,” one said. As the crisis hit, these investors understood how much cash and liquidity their portfolios needed, and reacted quickly.

Exhibit 1

ESG will be more integrated into investment processes.

Methods of integrating assessments of environmental, social, and governance (ESG) performance into regular investment-analysis process,¹ % of respondents²



¹Question: How do you integrate assessments of ESG performance into your regular investment-analysis process?

²Respondents could select more than one option; n = 37.

Source: McKinsey Institutional Investor Survey 2019

Test risk-factor allocations

Before this crisis, there had been a trend among leading investors to dedicate more resources to portfolio construction and asset allocation (Exhibit 2).

Risk-factor approaches to portfolio construction have received a lot of attention recently, and many say that these have done well in the crisis. One leader said, “our risk-factor approach has really softened the blow, particularly in our leveraged-loan portfolio.” Yet only a handful of leading institutions are truly embracing risk-factor approaches and following through on their implications for asset allocations and leverage. Those who implement these approaches do so largely because they believe that the promise of diversification failed in the last crisis, and that diversification across macro risk factors (equity risk, inflation, and rates, for example) is the right way to diversify. While it would be premature to declare victory, investors that use

risk-factor-diversification approaches say that they have been paying off.

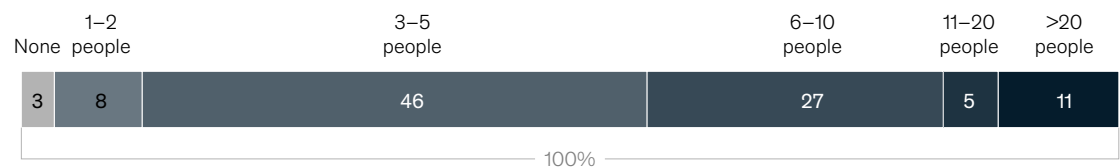
Act as true partners

There is no doubt that the current crisis is a moment of truth for institutional relationships. Some of our interviewees highlighted the importance of being good partners to external managers and peers, fairly balancing liquidity demands, and honoring deal commitments. “It is challenging to stomach because their liquidity is our illiquidity, but they are our partners and we want them to put capital to work,” said the chief investment officer of one North American endowment. The need for true partnerships also applies to funds with institutional investment-platform relationships. Some of these partners, particularly in areas such as commercial real estate, are suffering deeply. The current situation is putting the concept of long-term partnerships to the test.

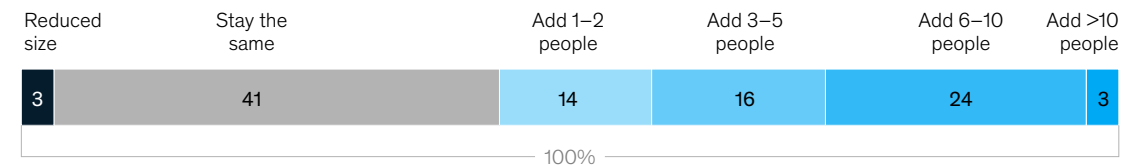
Exhibit 2

Most investors plan to expand portfolio-construction teams.

Current portfolio construction team size, % of respondents



Intended change to portfolio construction team size in the next 5 years, % of respondents



Note: Figures may not sum to 100%, because of rounding.
Source: McKinsey Institutional Investor Surveys 2016 and 2019

Exercise people leadership

A handful of leaders also said that they want to double down on their longer-term strategic agendas, especially on the talent front. Many private-sector employers worry about layoffs, for example, but one leader articulated a plan to accelerate recruitment efforts. “We’ve always believed that getting the best talent was what would make or break our success, and our organizational mission speaks to people, now more than ever.” Indeed, many see the current disruption as a moment of truth in their relationship with their people—an opportunity to build trust and loyalty with current employees and to differentiate themselves from other market participants in recruiting new talent.

The magnitude and ramifications of the pandemic’s impact on these large pools of capital—and on the public servants, pensioners, citizens, students, and others who depend upon them—will not be well understood for years. But these early signals appear to offer a directional sense: as in rosier times, the most thoughtful investors carefully separate temporary shifts from longer-term secular changes, trying to stay a step or two ahead of a deeply uncertain and rapidly evolving situation.

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