What overachieving institutional investors get right

No single practice or behavior explains success. Instead, top investors work across five dimensions to achieve excellence.

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We recently examined the performance of 40 of the world's largest institutional investors from 2004 to 2011. Conventional wisdom led us to expect that the firms with the highest rewards would also have taken the greatest risks. But it turns out that a number of "underachievers" had good but highly volatile returns, while a group of "overachievers" managed to generate virtually the same returns with half the volatility. On average, overachievers returned 8.1 percent annually and lost 16.1 percent during the 2008–09 crisis. (We use losses in these years as an indicator of the amount of risk that investors take on.) Underachievers managed a slightly higher annual return, 8.7 percent, but suffered much greater crisis losses, 23.8 percent.

To understand what might cause this disparity in performance, we interviewed more than 100 senior leaders from the overachieving firms. We found there is no single best-practice approach to "running money." Instead, these top investors owe their performance to an ability to align their organization and management approach across five key areas: the mandate, the governance model, the investment philosophy, the investment strategy and processes, and talent management (exhibit). These are the core pillars supporting successful institutional-investing platforms that create outsize value over time. Institutional investors that take a holistic approach to these pillars create a positive climate for strong investment management that is aligned with their specific missions.

For the top performers, however, this is just the starting point. Overachievers also ensure that the pillars are aligned, consistent, and self-reinforcing; that day-to-day practices are in line with each pillar; and that the pillars are designed to evolve as the institution grows and matures.

The choices each institutional investor faces with these pillars will be determined by its stakeholders, priorities, and operating environment. Yet all investors can benefit from a careful, disciplined analysis of their operating model along each of the five pillars. This type of analysis enables investors to create road maps for the evolution of their

Exhibit

High-performing institutional investors build their organization on five pillars.

	1	2	3	4	5
	Mandate	**Governance model**	**Investment philosophy**	**Investment strategy and processes**	**Talent management**
Key dimensions	Mission Investment constraints	Governance Policies, guidelines, and procedures Decision rights	Core beliefs Asset-class investment principles	Asset allocation Investment strategies Portfolio structure External-manager selection process Organizational structure	Investment and support-function structure Talent Compensation/incentives Culture
Common features	Explicit mission providing guidelines with respect to long-term objectives and constraints	Oversight structure and policies ensuring long-term sustainability	Clear investment philosophy articulated by a resolute leadership team	Flexible and cost-effective investment strategy to exploit competitive advantages	Direct alignment of mandate, philosophy, strategy, organization, and compensation

Source: McKinsey analysis

institutions in alignment with their visions of the future. Here, we briefly touch on the critical practices for each pillar.

The mandate

The investment mandate sets the direction for the entire institution. Yet, all too often, the mandate does not receive sufficient attention until serious violations occur, such as excessively risky investments or significant conflicts of interest. The best institutional investors ensure their mandates are clear and concise and guide everything from investments to performance management and governance. Typically, these mandates define the institution's overall purpose, and they provide high-level guidance on how to balance risk and return. They also outline the institution's approximate time horizon for investments given its purpose and how it will interact with its beneficiaries.

The governance model

Like the mandate, governance is a function that is rarely discussed when it is working well, but it can drag performance down when issues arise. For institutional investors, effective governance can be particularly challenging because of a number of complicated factors, especially the potentially conflicting goals of different stakeholders—for example, in jointly sponsored pension plans with government and union board members.

The large institutional investors we surveyed achieve optimal governance by adhering to four principles: clear accountabilities, board competence, efficient decision making, and effective fiduciary control.

The investment philosophy

An investment philosophy guides the development of a tactical investment strategy. The philosophy should be closely tied to the mandate and reflect the institution's core beliefs about the markets. For example, a pension plan may establish the minimization of risk and a focus on cash generation as philosophical principles. Well-constructed philosophies typically share five elements: a statement of market beliefs, a similar framing of asset-class beliefs, a fund-management style, a risk appetite, and a position on diversification.

The investment strategy and processes

Leading institutional investors ensure their investment strategies and processes flow naturally from their philosophies. The strategy, often framed as an investment policy, influences the asset allocation, outlines a specific strategy for each asset class (for instance, setting benchmarks for returns and specifying internal or external management), and defines the support organizations' structures, all of which are tightly aligned since they are highly interdependent.

The best institutional investors carefully design the investment organization to support their investment philosophies. For example, a philosophy that uses external managers for illiquid assets and internal managers for liquid assets would require a well-defined bipartite structure. The externally managed asset classes likely would report to a dedicated head, while the internally managed asset classes could report directly to the chief investment officer. Risk management is a critical part of the structure; leading investors view it as a value-adding partner to the business rather than as a control function.

Overachieving investors review both strategy and structure periodically. Typically, they monitor customer needs through interviews or surveys to ensure a responsive and aligned structure, and they pressure test the support structure against the

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overall organizational strategy (for instance, by managing for the lowest possible cost rather than considering quality first and cost second).

Talent management

Talent is at the core of any high-performing organization—and that is especially true for institutional investors. Senior leaders at world-class investment institutions spend a disproportionate amount of time and effort on recruiting, developing, and retaining talent. Underlying all world-class talent-management systems is a set of unique benefits that accrue to the people in the organization. The most successful public pensions and sovereign funds, for example, base their value propositions to employees on the higher purpose of furthering a social good (such as helping pensioners) or on a broader national objective (such as increasing national economic resilience). Many with direct-investment capabilities explicitly offer employees the opportunity to be true value investors, with the ability to deploy "patient" capital with minimal constraints.

Compensation, in contrast, hardly ever takes a leading role in the employee value propositions of leading institutional investors—even for the few that are unconstrained in their ability to pay top dollar to attract top talent. And although compensation, like many of the other topics we've touched on here, has complexities that can bedevil many investors, leaders find a way through the complexities.

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