McKinsey & Company

Private Equity & Principal Investors Practice

Why healthy institutional investors outperform

A strong mission and excellent talent management make for healthy institutions—and better investment performance.

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September 2020

In a time of extraordinary turbulence, institutional investors are searching for sources of stability. Our research has long indicated that, for organizations in every industry, the key to unlocking stable and sustainable performance is not to focus simply on results. Instead, the breakthrough comes when management applies equal rigor and resources both to how they make money *and* how they run the place—what we call organizational performance and health. We measure it through the Organizational Health Index (OHI). Across industries, those organizations that emphasize health deliver a total return to shareholders that is three times greater than their peers.

How does organizational health translate to the financial performance of the world's most sophisticated public investment funds? To understand more about health and performance at institutional investors (public pension funds, sovereign wealth funds, endowments, and the like), we surveyed nearly 5,000 employees at 23 global institutions that collectively manage nearly $4 trillion in assets, using OHI. We sought to understand employees' perceptions of their organizations' health and its drivers. We then considered the findings relative to investment returns.

The key finding is not shocking, but to our knowledge has not been empirically demonstrated before: the better the organizational health, the higher the investment returns. Our research showed that the degree to which employees believe in their fund's organizational mission and the quality of its talent-management practices were even stronger statistical determinants of investment performance than financial incentives. Whereas investment leaders are, at times, prone to writing off the "soft" elements of running an investment fund, indeed they matter. We recognize that 23 funds represent only a slice of the full institutional-investor landscape, that net returns tell only part of the performance story, and of course, that we cannot demonstrate causality between organizational health and performance. But our experience in the field suggests that the link is strong, and it is likely that strong organizational health helps support outperformance.

The survey results show that what matters most to achieving net investment returns is creating the right talent environment—one in which employees feel connected to the organizational mission, supported by leadership, guided in career development, and entrusted with autonomy. Hiring exceptional people is of course a big part of success—but helping them develop and thrive is also vital. It suggests that when an institution's leaders involve and empower employees through communication, consultation, and delegation, great things happen. Those qualities have never been more important than now, when COVID-19 has not only affected the investment environment but also challenged how investors operate—and underscored why their work is so meaningful.

In this article, we will review the research and outline the ways institutional investors can focus on the practices most closely linked to success.

Why health is important

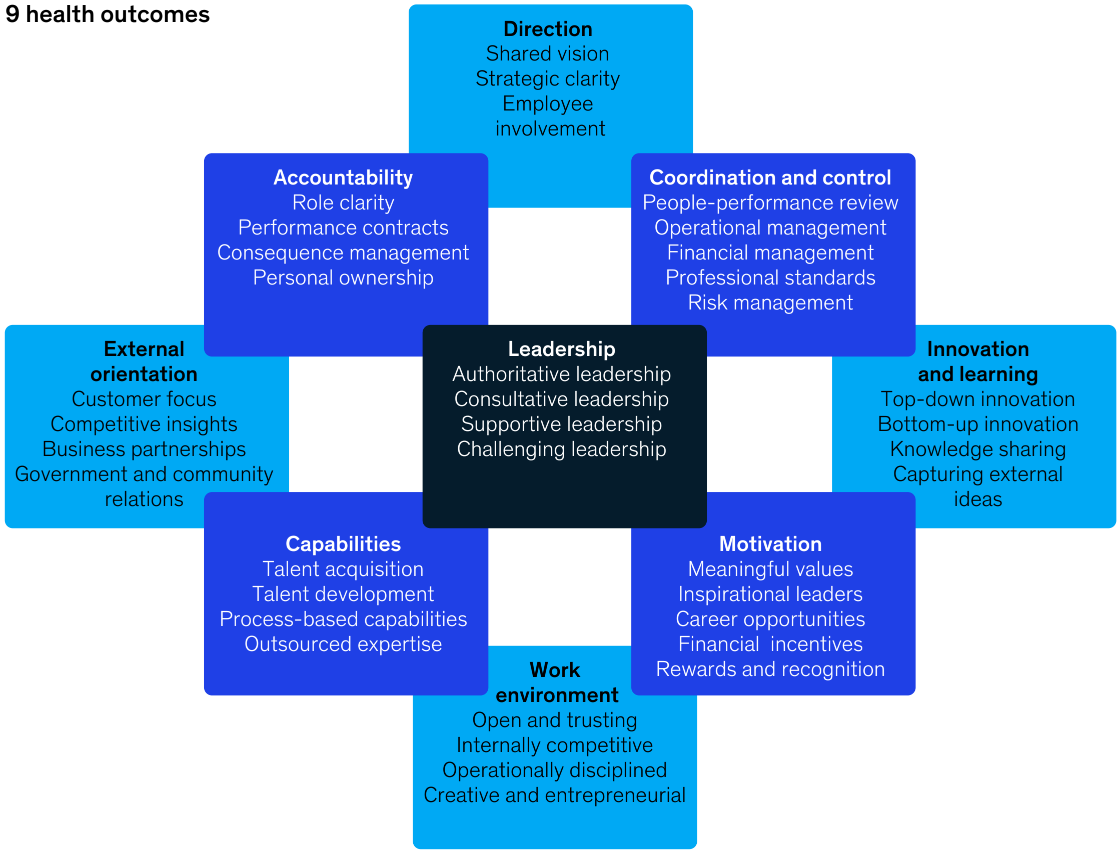
The search for returns has become much more complicated as investment returns have become increasingly challenged and investors have been tested by market volatility. Many pensions and other institutional investors set performance expectations decades ago, when low-risk asset classes offered high single-digit returns. Riskless returns at those levels are long gone, but the assumption that they will persist is built into the actuarial models of many, if not most, institutional investors. As such, investors must take greater risks to meet their expectations. Institutions have moved into diverse asset classes, in which success demands an ever-expanding array of skill sets and experiences. All of this has stretched the organization and increased its complexity, even as resource constraints and growing public scrutiny have tested it in other ways.

To understand how the organizational health of institutional investors is evolving in this environment, we turned to McKinsey's OHI survey. We surveyed all employees of the institution, then calculated scores for its overall health, its nine health

Exhibit

Thirty-seven practices are ‘what you do’—the behavior that drives each outcome.

9 health outcomes



“outcomes” (that is, the ways a company’s health is expressed), and the 37 specific management “practices” that tend to produce those outcomes (exhibit). In addition to the standard OHI survey questions, we also included several questions specific to institutional investors.[1] We conducted extensive statistical analysis to compare the OHI results with net investment returns.[2]

The ingredients that matter

At the highest level, we found a statistically significant positive correlation between organizational health scores and average five-year net investment returns. The OHI survey and benchmarking data explain nearly 60 percent of investment performance variations among institutional investors. Again, the data set used in our research was relatively small; if we were to measure the entire industry, the relationship might not be so definitive. But if we assume that the data are directionally correct—even, say, to the extent of 10 or 20 basis points—that level of impact would make a meaningful difference in portfolios worth tens of billions of dollars or more.

Looking more closely, several ingredients of organizational health showed stronger correlations than others.

High-returning funds tended to most effectively set and align the organization and its employees around its organizational mission. This bears strong

[1] We surveyed 4,859 employees at 23 institutions in Asia, Europe, the Middle East, and North America. All but one are public institutions; the one is a private university endowment.
[2] We also considered returns relative to benchmark but found that net returns are more directly correlated to OHI scores. Variation in net-return methodologies between institutions may exist.

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implications for public institutions whose purpose is often to support the livelihoods of their beneficiaries. Placing emphasis on the mission-driven nature of, say, a pension managing the future livelihood of retired public servants, or a sovereign wealth fund protecting the wealth of its nation, may translate to higher returns.

High-returning funds also demonstrated particularly strong *talent-management capabilities*. It is no secret that talent matters in investing. Across all 23 institutions, we saw statistically significant positive correlations between investment returns and *talent acquisition*, *talent development*, and *use of outsourced expertise*. Interestingly, talent development proved to be a more significant contributor to organizational health than financial incentives. Institutional leaders often ask about the connection between investment returns and financial incentives to employees. This research suggests that a focus on talent management may be at least as important as compensation, if not more so. And employees of the best-performing funds strongly agree with the statement "The fund seeks to hire the most qualified external candidates, whether from public organizations or from private industry." This result is striking in its impact, but not surprising in its conclusion: talent is key to strong investment performance.

An additional set of management practices common to outperformers is *consultative and supportive leadership*—that is, executives' embrace of trusting, engaging, collaborative styles. Institutions where employees saw leadership in this light showed a statistically significant positive correlation to investment returns. Employees in these funds who saw leadership fostering *a creative and entrepreneurial culture* felt they had the autonomy to experiment with new ways to improve investment performance, and had time away from day-to-day administration to focus on out-of-the-box thinking.

Closing the gap

How can laggard institutions catch up to their higher-performing peers? In our experience, three approaches to improve strategic direction, talent management, and leadership can help.

Direction and mission

Successful funds offer employment that is personally meaningful to employees—and help ensure that employees recognize the role they play in the fund's mission. This long-useful strategy is becoming even more important as the investing workforce becomes more millennial. Upon entering the workforce amid the 2008 global financial crisis, many millennials observed firsthand the weakening of the social contract as corporate scandals stripped workers of their pensions and companies cut jobs or closed their doors, leaving workers and their families financially vulnerable. The financial crisis understandably influenced the desire of some millennials to seek out investment jobs that help combat such challenges and bring meaning to the chaos of the world in which they have grown up. More recently, the humanitarian, social, and fiscal challenges wrought by the COVID-19 crisis may further motivate a mission-driven generation to seek out employment with a direct line to meaningful global impact.

Institutional investors are especially well positioned in this regard, and funds are taking both tactical and strategic steps to ensure that the link between the investment office and a meaningful mission is felt. For example, one institutional investor held "meet and greet" sessions among investment staff and retirees and displayed the thank-you notes they received afterward throughout the investment office. More strategically, several leading pensions are accelerating their commitment to environmental, social, and governance factors (including diversity and inclusion). More than a sentimental or symbolic impact, our research suggests that when employees feel connected to the fund's mission, investment performance follows.

Talent-management capabilities

There is no single path to great talent acquisition and development, the two critical talent-management capabilities. Our research[3] suggests that each institution must draw from a number of established practices, choosing those best suited to its particular context.

Talent acquisition at many institutions boils down to merely filling gaps when people leave or retire. A more strategic approach is to think about what will drive three kinds of value creation—business as usual, improvement initiatives, and new-growth opportunities—over the next five to ten years, while also identifying the critical roles that will be disproportionately responsible for delivering on that value. It is often 5 percent of critical roles that creates 95 percent of the value. Once these critical roles are known, the question becomes whether the most talented employees with the relevant knowledge, skills, attributes, and experience are in those roles. We rarely find that the best leaders are methodically deployed as such. Women and people of color are often among this group of underemployed talent.

Successful funds don't stop there. As we said, leading institutions tend to go beyond financial incentives. Instead, they add a second dimension to "what" was delivered by assessing "how" it was done as part of a robust performance management system. An investment track record tells only part of the story. Funds might also consider initiative and drive, risk behavior, adherence to values, and team leadership, among other qualities. And they provide managers with clear processes to minimize subjectivity and focus on development and coaching opportunities. Systematic talent management can help institutions adjust job design (for example, by removing administrative burdens), redesign career paths (through rapid advancement opportunities and special projects), and inspire better development (such as high-touch opportunities beyond formal programs). All of that can lead to more leadership exposure and influence, sooner—exactly what millennials are clamoring for.

Supportive and consultative leadership

Investment institutions tend to rely on strong talent. With exceptional people up and down the organization, it is often particularly important for senior leaders to ensure that they are listening to and empowering their teams. How can leaders of investment organizations do this? In most cases, it boils down to ensuring that formal or informal mechanisms are in place for decision makers to confer regularly with their teams, to seek their input on decisions, and to encourage employee entrepreneurship. Employees should feel like they are true thought partners and stakeholders to the organization and its leaders.

Three tactics can help. First, while most institutions have formal investment committees, not all of them are as effective as they could be. In many cases, investment committees are stymied by hierarchy and rigid processes. Consultative and supportive leaders should set the tone for the committee, making sure through their words and actions that everyone feels permission, and ideally an obligation, to offer countervailing views. This enables an organization to identify the highest-potential investment opportunities, while managing risks (relatedly, those funds in which employees

[3] See, for example, Aaron De Smet, Bill Schaninger, and Matthew Smith, "The hidden value of organizational health—and how to capture it," *McKinsey Quarterly*, April 2014, McKinsey.com.

perceived risk management to be sufficient had higher overall health).

Second proper delegation of authority on investment decisions is vital. Everyone needs to know which decisions employees can make on their own, which need discussion and debate, and which need approval from leaders. In our survey, agreement with the statement “Clear rules and guidelines exist to govern the investment decision-making process” directly correlated with organizational health. Appropriately delegating and clearly mapping roles for investment decisions provides greater autonomy and a sense of empowerment to those who are responsible and accountable, and gives those who are consulted and informed knowledge of what is happening, and the freedom to concentrate on their own work.

Finally, employees in higher-returning institutions cited an entrepreneurial culture and felt that leaders afforded them the freedom to experiment with new ways to improve investment performance. As financial markets become ever more competitive, investment leaders seeking opportunities to invest “between the lines” of traditional asset classes may find that encouraging creative thinking will serve them well.

Our research shows that, for institutional investors, good organizational health is connected to better returns. What is more, it’s also within reach even for public investment funds that are not blessed with extensive budgets. Indeed, organizational health is a kind of free lunch for investors: it costs little except time and energy, it doesn’t require legislative approval, it doesn’t entail compensation reform, and it makes the fund a better and more attractive place to work. This combination should lift organizational health to the top of the agenda for every institutional investor.

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The authors wish to thank Randy Lim and Nicole Lu for their contributions to this article.

Designed by McKinsey Global Publishing