The PODfolio Podcast Episode 23: Asset Class Mini-Series: Putting It All Together

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SPEAKER 1: Welcome to the PODfolio Willis Towers Watson's investment podcast series, where we'll give you an update on the latest developments across global markets and talk to expert guests on hot topics that matter to institutional investors and their portfolios.

[INTRO MUSIC]

LOK MA: Hello, podcast time with me, Lok Ma, as your host. And today we're finally wrapping up our asset class mini series, over the last few episodes we've visited the world of equities, bonds, illiquid secure income assets, alternative beta strategies, hedge funds, and private equity.

So now is the time to think about how to construct our portfolio by combining all of these elements and possibly others in a coherent way. And who better to do that than our Global Chief Investment Officer, Craig Baker. So first of all, welcome to the show, Craig.

CRAIG BAKER: Thanks very much nice. To speak to you lot.

LOK MA: So we've been through, I think, six broad areas for investing. And that wasn't even meant to cover the entire world of possible opportunities. And so now, if I as an investor, tell you Craig the overall level of return that I need and I ask you to please design me a portfolio out of these different elements, in a mathematical sense, there's an infinite number of combinations that you can come up with to achieve that.

So how would you actually go about that task?

CRAIG BAKER: Yeah, well it's a good question because the way portfolios are being constructed on a multi asset basis is really changing in the market. And so it's having this appropriate blend between the top down and thinking about some of the macro factors that are out there. But also the bottom up. And the identification of opportunities that don't neatly fit a label.

And what we tend to talk about is the total portfolio approach to portfolio construction, or TPA. And just to try and tease out what I mean by that, I'll perhaps compare it to the more traditional, strategic asset allocation approach, or SAA, that I would say most follow.

And so until recently, I'd say that's been the norm. That's where you conduct an asset liability modeling study. Often that will come up with a strategic asset allocation benchmark when you've decided how much you want in each asset class from a top down perspective and views on the expected returns and risks from every asset class.

And then you go and hire investment managers within each of those asset classes with a mandate to beat a particular index benchmark, for example. So an equity manager to beat the MSCI All World Index, a bond manager to beat, whichever bond index you think is appropriate for either the liabilities or your reason for investing in that bond asset class, in the growth assets.

And that's got the key advantage of simplicity. It's worked reasonably well in a period where simple equity and bond portfolios have done well. But what's actually been changing in recent times is that a lot of the largest investors in the world have started looking at this TPA approach that I talked about, the total portfolio approach.

And that reflects a much more bottom up approach to portfolio construction, where each individual manager or underlying asset is considered for the portfolio in terms of its impact at the total portfolio's return and risk in absolute terms or relative to liabilities in the case of a pension fund.

There's genuine competition for capital amongst all the bottom up ideas, and it's not just comparing it to other ideas in the same asset class. And you're not forced to own anything in a particular asset class if no good opportunities can be found. So that's really, in a nutshell, what this TPA approach is.

And that's certainly what we've been following for a number of years in our discretionary accounts.

LOK MA: And yes, I can see that what you're describing is very different than what we used to do. This kind of strategic asset allocation approach, which I would describe as kind of buckets and ranges. In other words, you used to just start with your different asset class buckets, and you split your money across these buckets in various ways. Within the confines of some agreed ranges.

So if your range for equities is 30% to 50%, if the equity market's looking attractive, you push closer to 50. If it's not, then you drop down to more like 30% and you put more of your money elsewhere. So that was the traditional approach. So why are we moving away from buckets ans ranges? You're saying this is better, but how much is the total portfolio approach better?

CRAIG BAKER: Yes, so interestingly, we did a survey of some of the world's largest asset owners in recent times. And half of the funds that we surveyed thought that a TPA approach would produce a performance advantage of at least a half to 1% per annum, versus the strategic asset allocation approach on a like for like terms in terms of the same team and quality of inputs.

And nobody surveyed believed it would result in worse outcomes. So you know, and that was a mix of funds that are already using TPA, the ones that are considering TPA, and ones that have stayed pretty much with SAA as their approach. So it certainly, in our view, is likely to lead to better returns at lower risk.

LOK MA: And this kind of evolution to the TPA, what is it coming from? Is it driven by external factors because markets are now behaving in a different way to before. Or is it just kind of natural innovation, so over time we've just gradually discovered a better way of doing things?

CRAIG BAKER: I think it's a bit of both. So if we take the latter first, I think there is a natural evolution that people have recognized that some of the best investment opportunities out there don't neatly fit a standard asset class label. In fact, the very fact that most investors are not set up to consider such opportunities because they've got the old SAA approach, and maybe they've got a team structured as an equity team, a team as a private equity team, a team as a hedge fund team, whatever it might be.

Because most investors are not set up to look at some of those ideas that don't fit one of those labels. There's effectively this supply- demand imbalance, meaning that they're often the most attractively priced things in the market. And so, just being able to free up your process so that you look at some of those things in itself improves expected returns. So we take an example, where does infrastructure debt fit in an SAA structure, the old strategic asset allocation approach?

Should it be part of the bond portfolio? Well probably not because it looks very different to the rest of the risk reducing areas of bonds. Does it fit in the real assets portfolio? Well probably not as it looks a bit low return relative to the other ideas in that space.

So it kind of doesn't get included in the old approach. But actually, in a TPA world, its inclusion might have a really positive impact on the overall portfolio's risk return trade off. Just because it happens to sit between the high risk ideas and the really low risk ideas doesn't mean it isn't something that's bringing diversity to the portfolio and helps produce a better overall risk return trade-off.

So that's kind of one thing that's been a natural evolution as people have started to look at newer areas and realizing they don't neatly fit. The second thing that is really a change is that there's much more of a focus on sustainability issues today and, arguably, TPA is really the only way you can truly consider proper sustainability risk.

So climate might be an example of that. And maybe if I bring out an example there. So let's say, well let's say that you want to increase your exposure to China within your equity portfolio. Under an SAA approach, you're likely to be put off that trade a little bit because it will probably significantly increase the carbon intensity of the equity portfolio.

So generally, China looks a bit worse on some of those carbon metrics today. Now that doesn't necessarily mean it will look worse over the course of the next 10, 20, 30 years in the decarbonization rate to try and be consistent with the Paris Agreement, but as of today, a lot of those Chinese companies look worse on carbon intensity.

And so you probably wouldn't do it in SAA terms. However, in a TPA world, you might think that the improvement in the overall portfolio's risk return characteristics of an increased exposure to China generally is so advantageous that we can manage our overall carbon budget. For example, by doing something elsewhere in the portfolio like reducing your listed infrastructure, exposure, or investing in some genuine climate solutions in the private equity space.

And so unless you're actually thinking about it as one single portfolio making trade offs in different parts of the portfolio, you're actually probably going to come to a suboptimal asset allocation than if you are able to think about it, bottom up and thinking about the whole portfolio as one.

LOK MA: So TPA then, in a sense, a lot of it is about kind of striking balances or even compromises across the portfolio. And so in carbon emissions you're not, it's not as simple as reducing it in every part of your portfolio. As long as you're getting the right effect overall and it's going in the right direction over time.

So I get that. And I mean the other thing that's kind of coming out of what you're saying is, it feels like the whole investment process has become kind of more multidimensional in a way. So it used to feel more like a problem you could just solve with a computer, kind of find me a portfolio that gives me this return, subject to the lowest possible volatility.

And nowadays, you're saying you want kind of more than one thing. Yes, the return is the main focus. But you also want to cut your carbon intensity as well. And yes, you're looking to manage short term volatility, but also you're aware of longer term risks like climate change or climate transitions.

And also to bring in this other theme that runs through our podcast, you've got the risk of poor decision making. If your manager hasn't got the right culture and everybody is making these decisions with a near kind of identical mindset. So, does the total portfolio approach help us to better solve this multidimensional problem of investing nowadays?

CRAIG BAKER: Very much so, and that's a key advantage of the approach. I mean it does make it a bit more time consuming and governance intensive, but ultimately we think that the nature of running investment portfolios just has become more governance intensive over time. If you want to continue to be successful. And as you say, it's thinking about overall portfolio quality, which is the term we tend to use. And thinking about it on multiple metrics and, as you pull one lever, it has an effect on another one elsewhere. And so this allows you to try think about multiple risk lenses, as we refer to them. And so, not just your traditional return on volatility metrics, we look at those, obviously.

But you can start looking at your climate risk, your I&D risks that you've got, be that at the corporate level on boards, be that in the decision making teams you've got within your asset manager. Within our decision making teams, within the asset owners decision making teams. It allows you to look at liquidity factors, complexity, costs, all of those things are multiple metrics.

And as you make a change or a proposed change to a portfolio you can look at, well, improves three of those lenses and makes two of them look worse. If I had another idea in at the same time, it actually balances that out because it makes the other two look better. And overall, I get a nicely balanced portfolio with a better overall risk return trade off and greater portfolio quality with the balance across all of these risks.

That are some of which are harder to model in pure, quantitative metrics, although we try quite hard to do that. Some of it you apply some qualitative judgment as well. But that's exactly what this TPA approach allows you to do that that the old SAA approach was a bit clunky for.

LOK MA: Right, and now we've talked about TPA, total portfolio approach in terms of the design philosophy and also some kind of practical examples of things that would be in a TPA portfolio that wouldn't necessarily be in a kind of old school strategic allocation type portfolio. I think it's time for maybe throwing some challenges at you, if you don't mind, Craig.

CRAIG BAKER: No, go for it.

LOK MA: So we get a better feel for I guess why you're confident that this is the best approach. So first off, I could look back over the longer term or even, actually, more recently, just over 2020 and a very difficult time for the global economy. And say that, actually, you know what, if you expect markets to perform reasonably well, especially over the long term, why spend so much effort finessing what's in your portfolio. As you say, this is kind of high governance stuff.

If I just passively tracked an equity index, I would have actually done pretty well over these recent periods.

CRAIG BAKER: Absolutely, and that simple equity bond portfolio has done very well over a decent period of time now. But we need to bear in mind what's been the right portfolio for the last 10, 20 years is rarely the answer to what's the right portfolio for the next 10 to 20 years. Obviously, it can be.

But it is very unusual for that to be the case. We need to think about what's driven markets. We've had pretty much falling interest rates for decades now, which has not only had an impact on bonds, but has had an impact on equities. If we're in an environment where we could see the rise of inflation rates increasing, that's a very different environment for whether a simple equity bond portfolio is going to continue to be a strong portfolio to have in place.

You've got other things going on in the world. You've got the rise of China as a superpower and its implications on investment markets. You've got the whole sustainability evolution, as well. And so you put all of those things together and the likelihood that the portfolio that's worked historically is going to be the one that works prospectively is relatively low probability.

And so we think that's even more reason for greater diversity in your portfolio than you've needed in the past. That brings out this question of whether, if you're going to run a nice, diversified portfolio that's cognizant of issues like sustainability. Can that really be done efficiently in an SAA world versus a TPA world.

And we contend that it's a lot better done in this new total portfolio approach.

LOK MA: But, of course then, the compromise you're striking is you need more complexity and a high level of governance. I mean let me throw another one out at you. When it comes to taking risk, shouldn't we just stick to what we know and that we're comfortable with? And I think that's very hard to argue against as a general principle.

I mean, no one's going to say, actually, let's risk someone else's money in something that we don't completely understand. So what do you say to that kind of school of thought, that we should just stick to what we know and not kind of stray into unfamiliar areas of taking risk.

CRAIG BAKER: Well the flaw in that argument is that it assumes that you really do understand all the risks inherent in the simple portfolio. Like equities, for example. Trying to actually understand what's driving equity markets over the next 5 to 10 years in advance is actually incredibly complicated. And understanding all of the macro elements of that, all of the changes that will come from government policy taxation, all of those sort of things.

It's incredibly difficult. It's always tempting to look at a period where equities have gone up a lot over a decent period of time and think, therefore, it shows the asset class hasn't got much risk in it. But of course, if we look over the long term, that's just not true for equities.

And all the principle of diversity is doing is saying that actually, we can never know completely all of the risks in any asset class. And so, having a diversity across a number of them is actually just a more sensible, risk balanced portfolio to be running going forward. And in most walks of life, we accept that you do need to have experts that have looked into all of the risks and opportunities that can be achieved and balanced across them.

You do that in every other area, why not in investment. And so we think it is important to run portfolios in that way.

LOK MA: Absolutely, and obviously, Craig, I'm throwing these thoughts at you to be deliberately provocative in a way. I actually think it's generally a good mental discipline, not just in investment, as you say, any walk in life, whenever you come across a kind of statement or principle that sounds so obviously true, to just think for one second and check that it actually makes sense. Give you a couple of examples outside of investment.

So firstly, the kind of inspirational or motivational messages I see on my Facebook feed. So the last one I came across is your own opinion of yourself is the only one that matters. Or when I watch a film with my kids, I really like this one. Believe in yourself and you can do anything you want.

So these things kind of sound so instinctively right, but is that actually sound advice? Probably not. And I think, again, you could say the same thing for when you're taking risks. Just keep it simple.

It just feels so obviously right. But if you think about it a bit, I mean, and here's an example I use a lot, which is, if you're about to have a medical procedure, I very much doubt you'll say to your doctor, you know what, can you just give me the simple version of your operation? So don't worry about the keyhole surgery or advanced equipment or whatever, to just do like the medieval version of what that operation is.

You're not going to say that, are you? Anyway, the last one I want to throw at you, Craig, this one is about conflicts of interest. And again, I'll introduce this with maybe another saying. This one is one of my favorites. Which goes like this, if you are holding a hammer, then the whole world looks like a nail.

In other words, the solution you choose is shaped by what you happen to be good at. And so if I think of the structure of I guess the investment business at Willis Towers Watson, and maybe similarly large organizations, lots and lots of research, experts in all these different areas. Some of whom, of course, have come on this podcast.

If I'm deliberately trying to kind of provoke you, Craig, are we a research and innovation driven business looking to justify our approach? Or is it the other way around, that we see that there is a good way of investing and therefore we build our capabilities around that good way of investing? In other words, is the solution driving the problem, or is it the other way around and how does someone from the outside looking in, how do they know which way around it is?

CRAIG BAKER: Yeah, well it's a good question because, to your analogy earlier, that's what you would want to do. Where does a surgeon always want to operate when sometimes you don't need to operate. And so you're always challenging that hammer and nail analogy.

Now clearly, I think very strongly that we've designed it around what's the problem. And come up with a solution that solves that problem. But it's right to challenge us on that, and I think the way that that can be done is to ask us, or whomever else you're talking about, to give evidence as to why do we think this portfolio is going to be advantageous.

And so I've talked through some surveys we've done of other investors who are not in that situation. These are single asset owners that are not conflicted in that sense. And they would agree that a half to 1% per annum advantage of TPA over SAA, look at what the largest and most sophisticated investors are doing around the world.

They all have diversified portfolios, pretty much, I mean there are one or two differences, but they pretty much do. Why is it advantageous to have lower risk? Because I often get heard, I hear this expression, you know, you can't eat Sharpe ratio, or whatever, it only matters about returns. But of course, that's not quite true, in a sense.

Because if you're in a cash flow negative fund, for example, having something with much lower volatility actually improves your outcomes. Because if you have a big draw down or fall in your assets at a time where you're paying out capital, it's then very, very difficult to ever make that back.

And so reducing volatility is advantageous. Throw in human reaction to what happens when you do have big draw downs and the like, and often that leads to wrong decisions being made and short term decisions over long term decisions, et cetera, et cetera. There is a massive advantage to having portfolios that are run in a much more balanced risk, lower risk, fashion.

So if you can achieve the same sort of expected returns with lower risk, that is clearly significantly advantageous, even for those with a long term horizon. And so all this diversity is doing is allowing that to happen. Now of course, it leads to the need for greater governance and time consuming and can be a bit more expensive.

But the costs of all of that are actually very small if done at scale, relative to the expected return pick up per unit of risk. And so we think that that's the sort of thing you should be challenging anyone that's offering to do this for you, is to how they can give evidence that they're able to produce better risk adjusted returns over a long period of time.

And ultimately, challenge them on why they've got an edge over other investors that are trying to do the same thing. Because this is a competitive game in investment. So those would be the things that I would say on that. The one thing I would say is that the evolution in the investment industry with more delegation has actually meant that the conflicts are potentially smaller, rather than larger.

And I know people think of delegation leading to more conflict, but actually here you're being ultimately judged on investment outcomes, whereas in an advisory capacity that's a bit more fuzzy as to how much of the return has come from the advice versus the ultimate decisions of the asset owner themselves.

So I think, if anything, if the simple approach was definitely the one that was likely to lead to better outcomes, I think you'd soon find that those offering delegated propositions would veer towards the simple approach. Because ultimately, it's more likely that they would keep the business and/or when performance fees or whatever structure that they've got in place.

LOK MA: Right, thank you Craig. I think those were the challenges that I jotted down before this chat. And I hope I managed to provoke some passionate responses out of you. So we're going to wrap up this series now.

So we've talked about some of the main areas for investment. We've then talked about this idea of a total portfolio approach, the idea that, actually, there shouldn't be these rigid boundaries between all these different investment types. And it's much better to think about the contribution of each investment to the portfolio across a number of criteria.

Risk and return, obviously, but also many other important things as well. So hopefully, that's given our listeners lots to think about. But I do have just one final question for you, Craig, which is with everything that we've just heard about, where do you actually start?

I mean, you're looking. You're talking about changing pretty much the whole way of looking at investing, as well as potentially bringing in new types of investments that you wouldn't consider under a traditional approach. So what's the first step in moving to a better portfolio?

CRAIG BAKER: I think probably the first step for us is to think about portfolio quality and try and identify what are the various ways you'd like to look at whether your portfolio looks attractive. And expected risk and expected return in traditional volatility terms, in case of risk, are clearly two very important ones. And that doesn't change.

But they're not the only ones. And so thinking about what are all the other factors, and that would include a number of sustainability ones, that includes that cost, complexity, liquidity. Make sure you do all of those. And just do an analysis of your current portfolio on those lenses and see how it looks.

That will be the starting point. And as with everything in investment, you don't have to jump from one end of the spectrum immediately to the other end of the spectrum. You can go across a whole spectrum of how far you want to go in the SAA to TPA world.

But this principle of being open to good ideas that come into your portfolio that don't easily fit a bucket that you'd previously had in place, just be more open to those. And that could be gradually getting more open to things that don't quite fit, or it could be going as far as to not using those buckets, but thinking about risk for multiple lenses.

But that would be the first step. And we've created a portfolio quality scorecard that could help people with that first step.

LOK MA: Thank you very much for spending your time with us, Craig. Much appreciated.

CRAIG BAKER: No problem. Nice to speak to you.

LOK MA: Also, hoping you'll rejoin us, Craig, in a couple of weeks for a discussion on climate related issues. But in the meantime, I'll wish a very good day to our listeners. Til next time.
[OUTRO MUSIC]
SPEAKER 1: You've been listening to a Willis Towers Watson podcast. For more information, visit Willistowerswatson.com.