Willis Towers Watson

Building strong foundations: Investment beliefs

What they are, why they matter and how to effectively implement them

Building strong foundations: Investment beliefs

Going from good to great

We have long argued that **good governance** is a key factor that distinguishes the very successful asset owner funds of the world.

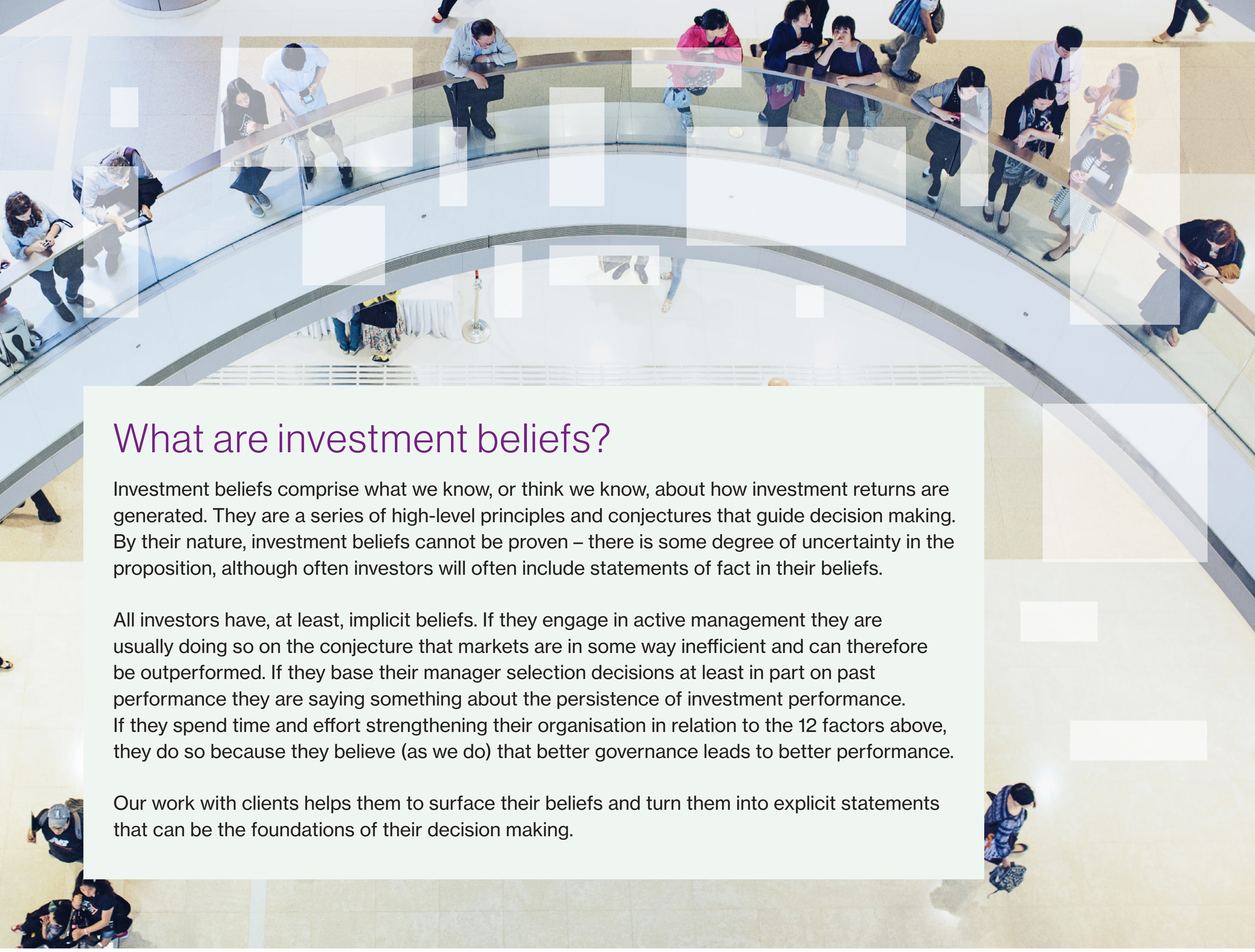
In 2007, Roger Urwin (Willis Towers Watson's Global Head of Investment Content) and Professor Gordon Clark (Oxford University) conducted a landmark study of investment governance*. The study was carried out by examining ten exemplar funds which were selected on the basis of their reputations for strong decision making accompanied by performance success. The key conclusion of the study was that **strong governance is a critical requirement to allow organisations to achieve above-average investment outcomes on a sustainable basis**.

The study identified 12 traits that are shared by the most successfully governed institutions. These are briefly summarised below:

'Core' business traits	'Exceptional' business traits
Mission clarity	Highly competent investment executive
Effective focusing of time	High-level Board competencies
Leadership	Supportive compensation
Strong investment beliefs	Competitive positioning
Risk budget framework	Real-time decision making
Fit-for-purpose manager line-up	Learning organisation

Here we focus on investment beliefs: what they are; why they matter; how they are decided; and, how they are effectively used. We set out some examples and a case study of how we worked with a client to develop their beliefs.

*'Best-practice investment management: lessons for asset owners from the Oxford-Towers Watson project on governance', Gordon L Clark and Roger Urwin, September 2007.



What are investment beliefs?

Investment beliefs comprise what we know, or think we know, about how investment returns are generated. They are a series of high-level principles and conjectures that guide decision making. By their nature, investment beliefs cannot be proven – there is some degree of uncertainty in the proposition, although often investors will often include statements of fact in their beliefs.

All investors have, at least, implicit beliefs. If they engage in active management they are usually doing so on the conjecture that markets are in some way inefficient and can therefore be outperformed. If they base their manager selection decisions at least in part on past performance they are saying something about the persistence of investment performance. If they spend time and effort strengthening their organisation in relation to the 12 factors above, they do so because they believe (as we do) that better governance leads to better performance.

Our work with clients helps them to surface their beliefs and turn them into explicit statements that can be the foundations of their decision making.

Why do beliefs matter?

We think there are six key benefits that come from having a well-thought-out set of explicit beliefs:

They save time	Beliefs can act as short-cuts in our decision making, saving a large amount of time.
They enhance discipline and consistency	Human behaviour and psychology can be detrimental to investment success. Investment beliefs provide a strong foundation to make good decisions, especially in times of stress.
They help fill gaps	Our knowledge of the world is incomplete and uncertain. We need beliefs to help us make decisions and avoid being 'paralysed' to inaction.
They help settle differences	A good belief process will surface and socialise sensitive issues, encourage constructive thinking and help settle differences of opinion.
They improve transparency	Beliefs help decisions to be subject to greater transparency and promote greater institutional memory.
They promote insightful action	The best investors have beliefs that are smart, incorporate deep insights and are thoroughly socialised (widely understood and acted upon).

How are beliefs decided?

As we said, all investors have, at least, implicit beliefs. Put a group of investors, or board members, together in a room and chances are their implicit beliefs will differ in some areas. This is an inevitable, and positive, reflection of different experiences and ways of seeing the world. The challenge for an organisation is how to bring those various implicit beliefs to the surface and work through differences to arrive at statement of beliefs that everyone involved can agree on.

Our work with clients typically starts with putting a series of statements in front of the key decision makers. We ask each of them to, confidentially, respond to each statement with replies, usually on a scale running from 'I completely agree with this' to 'I completely disagree with this'. We then play back the collective results to the group. We highlight those areas where members of the group are in complete or substantial agreement. For the time being those can be set to one side.

The really valuable discussion focuses on those statements where there is not agreement and here we look to sensitively draw out the reasons for the disagreement. Sometimes this is to do with experiences. Sometimes it is how members of a group interpret the same words. By surfacing these issues we find that often members close the gaps between them. Where differences remain we focus on a process we call 'settling'. Here we aim to see if we can arrive at a statement that allows all parties to say 'I wouldn't quite have expressed it like that, but I can agree with the sentiment'. This process often involves a lot of wordsmithing to arrive at statements that all involved can agree to.

Having reached a degree of accord on the various statements we then distil these down into a shorter set of distinct statements that the whole organisation can sign up to. Generally speaking, we think that organisations should have no more than 10, high-level investment beliefs. In the table below we include a selection of belief statements from investors around the world:

Good governance and responsible investment are key	APG – Netherlands
Portfolios are most efficiently managed as a whole, rather than as a collection of individual underlying sub-portfolios	Future Fund – Australia
Asset allocation is the key investment decision	NZSF – New Zealand
A long time investment horizon is a responsibility and an advantage	CalPERS – USA
Diversification is the key tool for managing risk	NEST – UK
Active management can add value, after accounting for costs	USS – UK
Valuation is always critical	UniSuper – Australia
Strong relationships support our success	OTPP – Canada
Consideration of environmental, social and governance ('ESG') factors can have a material impact on long-term investment performance	OMERS – Canada
Costs can significantly reduce returns and therefore must be accounted for in all investment decisions	Railpen – UK

Investment beliefs
A case study

Our client

Our client is a large defined contribution pension fund. It has a Board of 13 directors (principally from employer sponsor and union backgrounds), no Investment Committee and a medium-sized (17 person) in-house investment team.

Project scope

As part of a larger project on organisational design and governance, Willis Towers Watson worked with the client to build a customised questionnaire for the Board on a range of core investment beliefs and principles. The purpose of the questionnaire was to facilitate the production of a statement of core investment beliefs of the Board, which would inform all investment decision making throughout the organisation. The aim was to improve efficiency and clarify the high-level investment strategy.

The process

The beliefs project was split into two phases. Phase 1 involved surveying and consulting with the Board and Management, with the ultimate objective being the preparation of a draft statement of core investment beliefs. There were three stages within Phase 1.

Phase 2 involves the development of detailed sub-beliefs (nested under the core beliefs) to be developed by the client's management team and jointly owned by a newly formed Investment Committee. We facilitated Phase 1, whereas Phase 2 will be led by the client with input from us.

Phase 1

Stage 1: In conjunction with the client we prepared a questionnaire to be completed by the Board and Management. This survey sought the Board's and Management's views on a range of core beliefs statements.

The survey covered four areas:

- **Philosophy and Goals** – including competitive advantages of the Fund, the role of the Board and what the Fund's risk and return targets should be relative to.
- **Governance** – for example, the extent to which governance impacts performance and what decisions should be delegated by the Board.
- **Beta** – including the importance of diversification, whether tactical asset allocation works and whether beta or alpha is a larger return driver.
- **Alpha** – for example, whether alpha is attainable and how skillful managers can be selected.

Phase 1 (continued)

Stage 2: We then prepared a summary of survey outcomes. This highlighted areas of strong consensus amongst the Board, areas where there was polarisation of views and areas where there were no strong views. We use graphical techniques to highlight these outcomes as shown in *Figures 1* and *2*.

We carried out a workshop session with the Board to debate, discuss and highlight core beliefs apparent from the responses. This focused on any areas of ambiguity, polarisation or dispersion in the specific beliefs as revealed by the survey.

In this client's case, the results showed that there were many areas of strong consensus among the Board responses and this helped to identify a foundation for their core beliefs. There were also a few areas of ambiguity among the responses. However, where there was a polarisation of views, the workshop discussion revealed that it often came down to a different interpretation of the belief statement rather than the Board members having fundamentally different views. The workshop enabled all members to participate and, ultimately, to feel ownership of the subsequent belief statements.

Stage 3: Following the workshop, Willis Towers Watson took the conclusions of the survey and discussion with the Board and drafted a concise statement of core investment beliefs. This set of beliefs was then reviewed and refined by Management and a Sub-Committee of the Board.

Phase 2

From the settled set of core investment beliefs Management will prepare sub-beliefs for discussion with a soon to be formed Investment Committee. Willis Towers Watson will help Management refine the final statement and socialise it with the new Investment Committee.

Figure 1. **Philosophy and goals: Return measures**

While there is greater divergence of view on which return measures matter most, target return over inflation and return relative to stated objectives are generally viewed as the most important return objectives relative to target return over cash and return relative to peers.

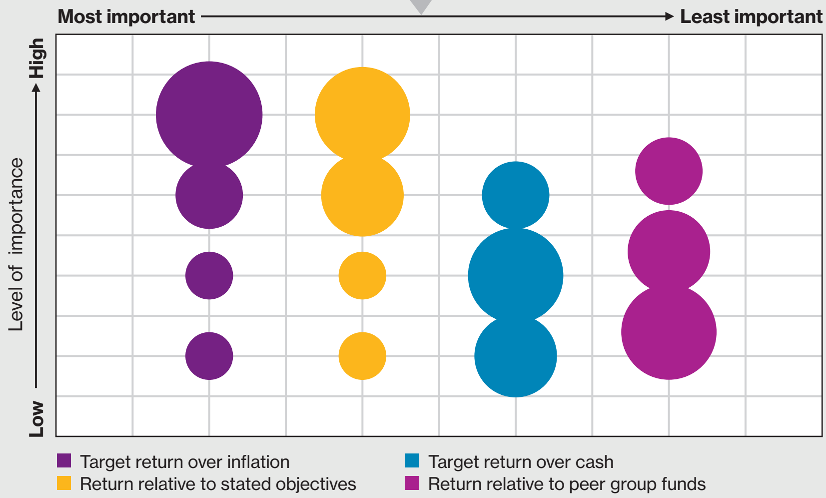


Figure 2. **Governance: Budget and goals**

The Board broadly believes that the likelihood of meeting objectives is related to the governance budget.

Issue	Belief proposition	No view	Strongly disagree	Tend to disagree	Tend to agree	Strongly agree
Governance budget and goals	The likelihood of meeting investment goals is directly related to the governance budget employed (which is a combination of skills, resources, processes and time available).				●●●●	●●●●
	With a finite level of governance, activities of the most importance (so, the greatest potential impact on the Fund) should be clearly identified and prioritised accordingly.					●●●●●●●●
	A key part of the Board's role is to build a governance budget that is competitively positioned.			●	●●	●●●●●
	Governance should be fit for purpose and matched to the complexity of the investment strategy. Very strong governance is required to make the adoption of complex strategies successful.				●●●	●●●●●
	Governance can be delegated to another body (for example an Investment Committee) as long at there remains appropriate Board oversight.				●●●	●●●●●

Clear belief that activities of the most importance should be identified and prioritised accordingly.

The Directors believe that:

- A key part of the Board's role is to build a competitively positioned governance budget
- Governance should be fit for purpose and matched to the complexity of the investment strategy
- Governance can be delegated with the Board providing oversight

Outcome

The Board has adopted the new core investment beliefs and is keen to see them embedded in all future investment decisions. Sensitive issues were maturely discussed and consensus reached in all areas, which has created a sense of ownership for the beliefs.

How are beliefs used effectively?

To be effective, beliefs should have three core characteristics:

Aligned

They should be signed up to by all decision makers and key stakeholders

Beliefs do not work if key decision makers can opt out of them when it suits. That said, people's beliefs might change as they process new information so there needs to be a mechanism where new ideas are carefully worked through. The most successful users of beliefs have an ongoing process to deepen them through internal debate and reference to new external thinking.

Beliefs are particularly subject to corrosion when there are personnel changes, so organisations should go to some effort to make belief awareness part of the induction process for new board or staff members.

Actioned

Portfolio decisions should correspond to them

Beliefs have little value if decisions are taken that are inconsistent with them. A critical question that decision makers should ask is: 'how is this planned action consistent with our beliefs?' If the answer is that it is not then that action should not be proceeded with. Taking a different angle, decision makers should ask 'what are we doing to exploit the beliefs we have?'

While beliefs are a necessary condition for good decisions they are not, on their own, sufficient. Effective decisions should be supported by appropriate and adequate analysis.

Accurate

Over time, outcomes should follow from them

This is a tougher challenge, but over time investors should look back and ask how well adherence to a particular belief has played out in practice. The challenge here is that investment markets are inherently 'noisy' – it is very hard to draw solid inferences from outcomes in the absence of a lot of data.

A concrete example of this in practice could be around returns from active management. If a fund pursues active management but does not, after a few years, have net-of-fee positive results to show (in aggregate) from it, then it should rightly question its belief either in active management or in its ability to select successful active managers.

Further information

To discuss how we can partner with and help your organisation with similar projects, please contact:

Jessica Melville
Senior Investment Consultant
T +61 (02) 9253 3436
jessica.melville@willistowerswatson.com

About Willis Towers Watson

Willis Towers Watson (NASDAQ: WLTW) is a leading global advisory, broking and solutions company that helps clients around the world turn risk into a path for growth. With roots dating to 1828, Willis Towers Watson has 45,000 employees serving more than 140 countries and markets. We design and deliver solutions that manage risk, optimise benefits, cultivate talent, and expand the power of capital to protect and strengthen institutions and individuals. Our unique perspective allows us to see the critical intersections between talent, assets and ideas – the dynamic formula that drives business performance. Together, we unlock potential. Learn more at willistowerswatson.com.

willistowerswatson.com/social-media

WTW-INV-AUS-2019-0703-WEB
willistowerswatson.com

Willis Towers Watson