Building strong foundations: Competitive positioning

How to identify and exploit your competitive advantages

Building strong foundations:
Competitive positioning

How to identify and exploit your competitive advantages

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

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

This note is part of our ***Building Strong Foundations*** series which addresses these 12 factors in turn. In this note we focus on Competitive positioning. By this we mean how organisations decide what their strengths and weaknesses are and how they exploit the former and minimise the impact of the latter. We explore one particular advantage that many funds have but don't often exploit as well as they might – their time horizon. We also look at how investors can score an easy win through instituting sound decision-making rules and why these are necessary. Finally, we showcase some examples of organisations who have clearly determined where their strengths lie and describe how we work with clients in this area.

Understanding competitive advantages

An organisation's strategic edge comes from a combination of its natural endowments (e.g. time horizon, ownership) and developed traits (e.g. disciplined investment frameworks, experience and insight of investment professionals).

Organisations rarely have a strategic advantage in each activity they undertake. The key is to understand areas of respective strengths and weaknesses. Identifying areas of potential strength is not sufficient – effort must be put in to identifying how best to create value from those strengths. Similarly, areas of relative weakness need not necessarily be avoided: the trick is ensuring that those areas do not become a source of value destruction.

Some potential areas of advantage are listed below:

Type of advantage	Examples
Natural or structural ("endowments")	• Scale • Location • Ownership • Time horizon • Client stability
Developed: *Organisational*	• Brand • People • Culture • Governance • Partnering
Developed: *Processes*	• Monitoring • Ability to innovate • Use of technology • Risk management • Decision frameworks

Competitive advantage is not necessarily correlated to either funds under management or organisational size. For example, the Yale Investment Office is globally regarded for the quality of its investment decision making. Compared to some other high profile institutional investors it does not have a particularly large investment team but has nevertheless been able to achieve its success through a disciplined investment process that draws on a number of the advantages listed above.

That said, some scale is usually required to develop an advantage. Recognising the challenge of competing against better resourced investing institutions, a growing number of investors are opting for what is sometimes referred to as an outsourced Chief Investment Officer (OCIO) model. In the OCIO model, investors delegate all the activities that would be undertaken by an in-house investment team to a 3rd party (evaluated for their source of competitive edge) who then contracts all further investment arrangements.

Capturing the long-horizon premium

Many investors have a potential natural advantage in being long horizon investors. This applies to many pension and sovereign wealth funds and most endowments (which are often set up to invest in perpetuity). Research by Willis Towers Watson's Thinking Ahead Institute[1] suggests that the premium available to long-horizon investors might be as much as 1.50% per annum. That is very significant, particularly in a world of relatively low expected returns.

Despite this potential premium, many investors fail to exploit their long horizon advantage because they have failed to develop a long-horizon mind-set. There are many facets to developing a long-horizon mind-set but key amongst them are:

- Having strong investment beliefs that anchor decision making.
- Having an acute self-awareness and awareness of others, particularly the behavioural biases to which we are all prone.
- Having strong internal and external alignment. Trust, transparency and time spent on relationships are key here.
- Focussing assessment and measurement on the long term and on what matters. Too often investors are distracted by the short-term 'noisiness' of the markets or their managers.
- Being an active and engaged owner – acting as if you are the asset owner.
- Developing a long-term culture through hiring staff and engaging partners who genuinely believe in long-term investing and act accordingly.

[1] Thinking Ahead Institute: The search for a long-term premium

Developing decision making frameworks

Sound decision-making frameworks are a relatively easy win for most investors. Despite this it remains surprising how many investors act without such frameworks. It's now well known that human beings are subject to a number of behavioural biases and that these affect professionals as much as lay people. Examples of such biases include:

Examples of biases

Representativeness
results in investors labelling investments (commonly investment managers) as good or bad based on their recent past performance. Consequently investors invest more in those investments that have performed well, expecting them to continue to do so, and, conversely, divest from those that have done poorly.

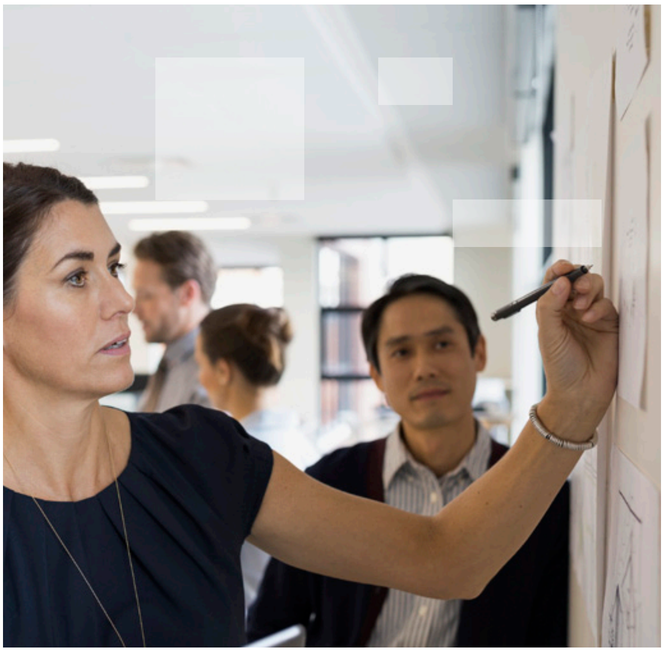
Loss aversion
leads investors to not sell poor investments because to do so would confirm they have made a poor decision.

Familiarity
causes investors to have a preference for familiar investments despite obvious gains from diversification. Local and home biases are examples of familiarity biases

Anchoring
the tendency to hold on to a belief or event and then apply it as a reference point for future decisions. For example, those who suffered financial damage during a financial crisis might view that period as more like the norm than the outlier event it was.

Trend chasing
manifests in the mistaken belief that historical returns predict future returns.

Over confidence
when investors tend to over-estimate their skills, abilities and predictions for success.[2]



Unguarded against, these biases have the potential to lead to actions that destroy value. Illustrating the significance of the Representativeness bias, one study[3] looking at stock market investors' historical returns found investors in the US equity market had underperformed the market average by 130 bps (1.3%) p.a. over the period 1926-2002. The study found a similar underperformance (150 bps) over 19 international markets for the period 1973-2004. A follow-up study[4] found an even more alarming result with respect to hedge funds. There the research showed an underperformance of between 300 and 700 bps p.a. depending on specification and the time period used.

Sound decision-making frameworks guard against these biases by setting out clear, well-thought through and adaptable rules to enable consistent decision making even on uncomfortable or more difficult subjects. They also clearly document any decision-making delegations that are in place and ensure that there is a process in place for reviewing how decisions made adhere to those rules. When properly used, investment beliefs are a form of decision-making framework. For example, by specifying in advance how they think investment markets behave and what the important factors that drive investment returns are, investors have an anchoring point against which to evaluate decisions.

[2] As Nobel Laureate Daniel Kahneman observed: *Overconfident professionals sincerely believe they have expertise, act as experts and look like experts. You will have to struggle to remind yourself that they may be in the grip of an illusion.*

[3] What are stock investors' actual historical returns?, Dichev, 2004

[4] Higher risk, lower returns: What hedge fund investors really earn, Dichev & Yu, 2010

Best practice competitive positioning examples

Canada Pension Plan Investment Board (CPPIB)

CPPIB is a professional investment management organisation that invests the funds of the Canada Pension Plan (CPP) on behalf of its 20 million Canadian contributors and beneficiaries. It is recognised globally for the quality of its governance arrangements.

CPPIB's comparative advantages – inherent to the CPP Fund and developed through their strategic choices – afford the organisation a distinct perspective in making its investment decisions.

Structural Advantages

Long horizon	Scale	Certainty of assets
Affords us the patience of a true, long-term investor	Allow us to participate in large, complex transactions	We can capitalize on opportunities when others can't

Developed Advantages

Internal expertise	Expert partners	Total Portfolio Approach
A world-class investment team driven by a strong sense of purpose	Relationships based on trust, respect, and mutual benefit	A portfolio built on assessing risk rather than targeting specific asset classes

More information on CPPIB can be found at: http://www.cppib.com/en/.

New Zealand Superannuation Fund (NZSF)

NZSF was established to help the New Zealand Government deal with the fiscal challenge of an aging population. The Fund is managed by a professional investment management entity – the Guardians of New Zealand Superannuation – which has a mandate to invest the Fund on a prudent, commercial basis in a manner consistent with: best practice portfolio management; maximising return without undue risk to the Fund as a whole; and avoiding prejudice to New Zealand's reputation as a responsible member of the world community.

The Fund has four "endowments" or competitive advantages – core features of the Fund that are derived from how they were established and which help guide them in their investing decisions. The four endowments are:

1. Long Fund horizon – they have the ability to invest in illiquid assets and to ride out short-term market movements.

2. Certain liquidity profile – their public funding formula gives them certainty over their cash flow.

3. Operational independence – Fund's investments are made on a purely commercial basis.

4. Sovereign status – this allows them to pay lower tax in some jurisdictions and is often favourably regarded by business partners.

In combination, these "endowments", which stem from the way the Fund has been set up, optimise the Guardians' ability to generate superior investment returns for the Fund.

More information on NZSF can be found at: https://www.nzsuperfund.co.nz/

Deciding whether to insource or outsource an activity

Many investors outsource all their investment activities to one or more third parties. They typically do this either because they don't have the scale to develop any internal resources, or investing activity is a distraction from their core business, or they recognise that they do not have, and are unlikely to be able to build, the core competencies required to manage investments. In other words, they don't view themselves as having an advantage in that area of investing.

Few, if any, investors insource all investment activities. There is however a trend amongst the largest investors to undertake more and more activity in-house.

Academics Clark and Monk[5] identified five key factors pushing institutional investors to move asset management in-house:

1. Access: There are instances where the third party vehicles are not attractive, and access to a given asset or market can be more effectively achieved on a direct basis.

2. Alignment: Principal-agent problems are pervasive in the asset management industry, and some institutional investors view in-sourcing as a useful mechanism to minimise agency costs.

3. Capabilities: By developing an investor's internal resources, all aspects of the organisation's capabilities are improved, as internal teams can identify 'unknown unknowns' about the business.

4. Performance: Perhaps the most cited reason for in-sourcing by institutional investors was the desire to maximise net-of-fee investment returns.

5. Cohesiveness[6]: Managing assets in-house offers an investor the ability to think critically about how to tailor a portfolio to meet its needs (as opposed to trying to cobble together a series of external mandates).

While these five factors are a useful way for investors to sort which activities they might undertake themselves the investor still needs to think about the factors that will drive them to have an edge in that activity.

How we help clients understand and exploit their competitive advantages

When we work with clients on this subject we approach it in a structured, systematic way. We typically start with a general discussion (or reading materials) about the nature of competitive advantages and give examples of how other investors have characterised their own.

With a common understanding of terminology in place, we then work with the client to reveal their beliefs about the areas they think they have an advantage in. This might take the form of interviews or questionnaires. Where possible we like to go broadly within an organisation because, as with investment beliefs, often individuals will hold different views and it is important to surface and settle those differences. Depending on the nature of the assignment we might extend our analysis to an asset class by asset class assessment considering which, if any, of the structural or developed advantages might give them an edge in a particular area.

Having established areas of potential advantages we then work with the client to help them exploit them. Here we focus particularly on how they make decisions. This might be decision rules or decision rights (i.e. who gets to decide what). It may also be an input into the design of their investment strategy itself. Follow up work focusing on mindset and culture ensures that the behaviours required to exploit the advantage are being put into practice.

Further information

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

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

[5] Clark and Monk: Principles and Policies for In-House Asset Management

[6] Clark and Monk use the term 'Sustainability' but we have replaced this given the overlap with other uses of that term in the investing context.

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, optimize 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-2019-0315

willistowerswatson.com

Willis Towers Watson