Why good governance is paramount for institutional investors

SEI director of strategy on why money managers have responsibility to 'make good on a pension promise' and ensure organizations can sustain their missions

By James Burton (Aug 11, 2020)

Good governance is the cornerstone of risk management – and never has that been as important for the institutional investor.

Kendra Kaake, SEI's Director of Investment Strategy for the Canadian Institutional Group, told WP, in part one of our interview, that in any market environment, there are challenges and opportunities, but that these are certainly "new times".

Remaining focused on the big picture is critical and institutional money managers must keep an eye on economic and geopolitical trends, interest rates, global demand for return, management of expectations, currencies, commodities, liquidity, scalability of strategy and portfolio construction, to name more than a few.

However, Kaake stressed that good governance and accountability is paramount. She said: "It's the behavioural rather than the quantitative aspects of investing, in my experience anyway, that tend to create the most problems for these investors, and retail investors as well. That's actually been one of the biggest lessons of my career."

"Without a doubt, the biggest risk we face as investors is bailing out after that left-tail event and those decisions that are made in extreme markets can leave permanent scars on a portfolio or an organization. If that happens, we can't just say to ourselves, we had a good run, so maybe it's time to close our doors. We have a responsibility to help ensure that our clients make good on the pension promise or on the ability to sustain its mission."

Today's market environment is putting that to the test and Kaake believes the global context of the COVID-19 pandemic is, understandably, creating a lot of anxiety for investors. The majority have seen material changes in the way they live, work, conduct trade or globally interact. But, she added, it's important to remember that the threats to defined benefits, sponsors and their ability to meet their obligations can take on many forms and has always involved constantly assessing downside risk in anticipation of potential surprises, particularly with respect to unexpected contributions, which tend to happen at "exactly the wrong time".

Kaake said there are also risks to the broader organization and that strategy should always be reviewed in light of how clients' business forecasts have changed and how their portfolios are positioned.

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Kendra Kaake, SEI's Director of Investment Strategy for the Canadian Institutional Group

"They go hand in hand," she said. "The pension plan, for example, is part of a sponsor's capital strike. The past several months have only highlighted how crucial it is for those of us who are in the investment management industry to create goals-based portfolios, and to continue in our efforts to focus on risk management from a top down, total enterprise level. "Every effort has to be made to tie their investment strategy to their specific situation. You can't think of managing an investment portfolio in a silo without any recognition of the broader business. It's less than optimal and can lead to unintended consequences and not the outcomes you want."

Asset allocation and ensuring you don't miss out on gains - an often irreversible error – are other areas money managers must be cognizant of, as is having an effective reporting structure. Kaake added: "This prevents harmful behavioural biases from derailing the decision-making process. And that's why it's important to have access to investment alternatives and strategies which are appropriate at the specific client level."

Moving forward, this can help mitigate the low-return environment, which has presented the industry with huge challenges. But, as Kaake pointed out, this is nothing new. Through the past three decades, we've trended towards lower rates. Coupled with a very expensive market, she expects returns over the next three to five years to be a lot more like 4-5%, rather than the 7-8% that a lot of institutional clients have historically experienced.

She said: "Based on where we're at now, in order to continue with, and frankly support, the kind of returns we've become accustomed to will likely need a shift into zero and even negative real rates, which certainly isn't our base case. But I do think we tend to overcomplicate this conversation, because in simple terms all you really need to do is think about the fact that two decades ago, we were clipping 6% coupons from the Government of Canada 10-year bonds, one decade ago, we were clipping 3.5% and today that's below 1%."

"If you layer on a risk premium for asset classes out the risk spectrum - and those remain relatively stable through time, of course - as far as our models are concerned, the return expectations at the total portfolio level are going to be anemic relative to historical view of those expectations."

"The net result is that investors will continue to be forced out the risk spectrum, moving into alternative and private markets, taking on liquidity and cash flow risk to generate additional returns. Of course, the most recent downturn hasn't changed that dynamic."