STATE STREET

Speaking of Alpha

Helping Superannuation Funds Transition to a Total Portfolio Approach

A conversation with Frank Smietana,
Sandra Ng, Yulan Lu, Clive Maguchu

Asset owners are increasingly challenged to provide their beneficiaries with outcome-based solutions that address individual preferences around risk, liquidity and ESG concerns. Traditional portfolio management approaches that allocate to specific asset classes were not designed to deliver these types of outcomes. In response, forward-looking asset owners are taking a Total Portfolio Approach (TPA) by shifting from asset class to risk factor exposures and promoting a collaborative culture across their investment teams, focused on delivering targeted outcomes.

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Our Speaking of Alpha series features insights and commentary from State Street Alpha experts on data, operations, technology and services. In this conversation, Sandra Ng, Yulan Lu and join Frank Smietana to discuss what is driving the growing interest in TPA and the technological, cultural and regulatory aspects required to implement a successful TPA program.

Frank: Give us an overview of TPA in the context of a multi-asset portfolio.

Clive: TPA focuses on diversification through portfolio factor exposures rather than asset class exposures and presents a goals-based way of investing. This contrasts with traditional Strategic Asset Allocation (SAA), which is structured around asset class-based allocations and benchmark comparisons.

Importantly, TPA is about managing the portfolio holistically rather than in silos. This allows all asset classes to be considered for how suited they are to help a portfolio achieve its goals, resulting in a well-diversified portfolio.

Frank: How does TPA differ from strategic asset allocation and what complexity does that add from a data, analytics and technology standpoint?

Sandra: TPA is a bottom-up approach compared to the top-down SAA approach, requiring each investment opportunity to be evaluated for its impact on the portfolio's stated goal, whether that's managing risk, maximizing returns, looking for an absolute return or other factors. This creates competition for investment capital amongst team members and stands in sharp contrast to filling an allocation within a particular asset class.

The holistic aspect of TPA adds complexity to the investment process because firms now require a central repository for their investment data to aggregate portfolio exposures and monitor risk across a common set of factors. The technology challenge is that firms typically use asset class-specific risk and portfolio management systems, resulting in multiple data silos across the book of assets that must be harmonized. Since TPA focuses on allocating to risk exposures, firms need risk analytics across their entire investment universe.

TPA also requires the ability to aggregate portfolio information in different ways. While investment professionals need to analyze the portfolio in a common, factor-based language, client and regulatory reporting is largely on an asset class basis. Maintaining a consistent, timely and holistic portfolio view is critical to the success of TPA.

TPA is a holistic approach to managing the portfolio that focuses on diversification through factor exposures rather than asset exposures.

Frank: What are some of the data management requirements that need to be addressed to support a viable TPA program?

Yulan: In contrast to SAA, where the focus is on aligning portfolios with benchmark and index data, TPA requires factor-based data and analytics from multiple providers to be ingested and validated. Data for alternative and private assets is often less transparent, accurate and timely than that for publicly traded securities. In many cases, private asset data is maintained in spreadsheets, where data lineage is difficult to establish. Enterprise data management tools can facilitate the ingestion of large data sets across asset classes, and harness AI for advanced data validation and curation.

Externally-managed assets pose another challenge. TPA requires portfolio managers to look through fund-of-fund structures to determine holdings, exposures and investable cash. Bringing all this data onto a centralized platform provides portfolio and risk teams with timely information and helps them make better informed allocation and overlay decisions

Frank: How can TPA deliver better outcomes for plan members, and what advantages does it offer compared to traditional asset allocation approaches?

Clive: TPA focuses on ensuring a portfolio achieves the investor's desired goals. In theory, plan members can be more explicit about the financial outcomes they want from their investments. Funds have more flexibility with their asset allocation to address those needs. For plan members with specific preferences in relation to risk appetite, sustainability and climate goals, TPA allows the portfolio to align with those objectives, without being tied to asset class boundaries or overly sensitive to what other funds with different member profiles hold in their portfolios. These objectives include liquidity, income generation, inflation protection and drawdown, aspects which are not typically considered in traditional asset allocation.

Additionally, the more dynamic nature of TPA implies that plan members are likely to be better off with funds that can shift their investments in response to changes in the investment environment. This dynamism does allow tactical shifts to either protect the portfolio or take advantage of opportunities that can provide better outcomes.

TPA in theory provides funds with greater flexibility to meet investor's desired goals by removing the confines of asset class boundaries.

Frank: What organizational and cultural changes should asset owners and super funds anticipate as they consider transitioning to TPA?

Yulan: From a cultural perspective, adopting TPA requires a change in the way teams interact and make decisions. Rather than focusing on a single domain or asset class, TPA requires teams to think more holistically and consider a broader range of factors in their decision-making. This mindset shift requires executive sponsorship, clearly specified investment goals and a culture that supports both top-down and bottom-up views.

Ultimately, a culture of mutual respect and trust will encourage open communication and enable teams to work collectively to achieve their goals. To facilitate this kind of thinking within an organization, the investment team needs to be structured with an emphasis on multi-asset experience and collaborative decision-making.

For TPA to work well, the internal culture and incentives must be aligned with the idea of a single, multi-asset portfolio. Under SAA, incentives tend to be based on asset class-specific performance.

Sandra: New South Wales **Treasury Corporation's transition** to the total portfolio approach took three years to complete. The chief investment officer (CIO) has said it's not a hard process, but it is a cultural journey. You can't design a good process and give teams an instruction manual. It requires cultural change to shift people's mindsets so you're all working towards the same goal and contributing to the total outcome of the portfolio. The key is encouraging greater data-driven collaboration. Providing timely fund-level and macro data to investment and risk professionals is an important pillar of support.

TPA is a journey that requires cultural change to shift people's mindsets to work towards the same goal and contributing to the total portfolio outcome.

Frank: What's driving the growing interest in TPA and how are asset owners integrating it in their investment allocation processes?

Sandra: Recent studies highlighting the successful adoption of TPA support the move to an alternate approach. For example, the Future Fund, Australia's sovereign wealth fund, and other **industry peers** have demonstrated that TPA can produce compelling returns compared to that of other superannuation funds. That's paved the way for more asset owners to integrate aspects of TPA into their investment process.

The increasing need for funds to assess their investments through multiple lenses and consider aspects such as climate change, inclusion, diversity and governance is another driver. Likewise, recent market trends resulting from the (COVID-19) pandemic emphasize the importance of integrating liquidity into portfolio construction. Those aspects that aren't directly tied to the strategic asset allocation process require a framework for analyzing portfolio risk across a wider range of factors.

We also see geographical nuances driving change. In Australia, where consolidation of the superannuation industry is resulting in larger funds, in-house investment teams are looking for a holistic fund perspective. That's driving organizations to collaborate more closely and come up with a competitive, differentiated approach to generate the best returns. Having a greater focus on absolute return outcomes, operating from a 'whole-of-fund' view and understanding the portfolio's factor exposures, all make sense to the asset owners.

Frank: Discuss the regulatory and internal constraints that asset owners need to be aware of as they consider transitioning to TPA.

Yulan: One obstacle we've observed is a fund's ability to access the information needed for investment decisions. That's an area that needs to be clarified at the outset by each of the core functions, including risk, investment and regulatory. Organizations need to address several issues. What is the specific focus for each of the factors, how do we measure the success of a factor-driven decision and what are the regulatory reporting implications?

From a regulatory perspective, it's important to note the reporting requirements in each jurisdiction and ensure the TPA framework considers them. For example, regulators may require reporting on allocations and exposures across different asset classes and risk appetites. Regulatory requirements are meant to protect members and the industry. From a TPA perspective, funds should deliver better investment outcomes for their members and present balanced investment options with clearly articulated risk and return profiles.

Clive: In Australia, the 2021 **Your Future, Your Super** (YFYS) Act mandates annual performance tests for superannuation funds. Basis risk is a major concern, even for funds that are outperforming the test. Investing in assets that are not included in the benchmarks for this test can be seen as a risk not worth taking. Also, the fee comparisons that are included in YFYS mean that high-fee investments don't appear as attractive, even though they might produce better after-fee returns.

These reforms have brought about a noticeable change of approach from the large superannuation funds. Any change to investments impacts how that fund looks in the comparison and this matters because it is an industry-wide mandate. The YFYS performance results are published to facilitate comparisons between funds. Having a fund that performs well on the test is important, and deviating too much from those benchmarks opens the fund to the risk of underperforming.

Frank: What role do private assets and ESG play in TPA and what challenges do they present?

Clive: TPA targets true diversification, and alternatives provide that (diversification). 2022 was a great example where listed assets were all positively correlated in a down year and alternatives provided considerable diversification. The evidence we've seen across organizations that are implementing TPA reveals a **greater allocation to alternative assets**.

This introduces some challenges, including an accurate assessment of a portfolio's liquidity position, particularly in times of stress. Accessing holdings data across public and private markets on a holistic and timely basis is challenging due to the inherent illiquidity and complex structures of these asset classes and non-standard ways of reporting holdings and performance.

In terms of having clarity across your whole portfolio and current positions, alternative assets can limit a fund's agility. Funds want to avoid overextending or moving in a direction not supported by their current positioning. This could impact tactical decisions if actual exposure isn't known on a timely basis.

Another challenge involves aligning alternative assets with the different factor exposures pertinent to public assets, or vice versa — ensuring your risk analytics consider a common set of risk factors across the entire investment universe.

Sandra: ESG strategies range from very basic negative/positive screenings, where inclusion or exclusion is generally sector- or geographic- or region-based. As funds incorporate broader objectives such as reducing greenhouse emissions, investing in sustainable energy or increasing workplace diversity, recognizing that every investment opportunity has an impact on achieving these goals is one way TPA helps with the implementation of ESG strategies.

Alternative assets can provide considerable diversification and evidence suggests implementing TPA reveals greater allocation to this asset class.

Frank: What technology and services should super funds consider to support their TPA transition?

Yulan: From a technology standpoint, organizations need to evaluate investment platforms that can cater for multiple securities and asset classes, accommodating both public, private and alternative assets. A centralized data foundation for aggregating, validating and distributing data to risk and investment teams is also key. Finally, interoperability with analytics and data providers ensures investment professionals can leverage best-of-breed content that supports the unique demands of their investment process.

The growing interest in outsourced asset servicing also plays a role in helping super funds transition to TPA. Trusted service providers bring a wealth of knowledge and experience with multi-asset portfolio construction, risk analytics and data management. Organizations can use those services to expedite the launch of their TPA program.

Adopting a platform that can cater for multiple securities and asset classes, accommodating public, private and alternative assets is key.

Frank: How are we helping asset owners leverage the benefits of TPA?

Clive: From an investment perspective, we are helping asset owners incorporate alternatives into their portfolios and analyze them on the same basis as publicly traded assets. For example, if adjustments aren't made or constraints applied to alternatives, they risk looking artificially attractive compared to listed assets in a mean variance optimization process.

Our research makes it easier for asset owners to fully appreciate the diversification and return they earn from alternatives and make valid comparisons to public assets. Essentially, we're helping asset owners implement strategies that incorporate alternatives holistically.

We also have a strong focus on dynamic asset allocation, which uses proprietary tools such as our investment sentiment and market regime indicators. These indicators enable clients to assess all asset classes consistently, providing investment teams with views across the whole portfolio when deciding which tactical trades to implement. This framework provides our clients with a structure and research methodology that support a dynamic approach to managing their investments.

Sandra: One of our key initiatives is **State Street Alpha**, a single front-to-back asset servicing platform across the entire book of investment assets, including portfolio management, trading and compliance. Public and private asset class risk across the portfolio can be managed in **Charles River Investment Management Solution** using analytics from our partners MSCI, Factset and Qontigo.

Our outsourced asset servicing, data management and governance solutions help deliver timely and accurate data to support portfolio-level analytics and enable teams to run simulations and stress tests. For example, looking at different sets of possible investments and their impact on the portfolio as well as comparing competing investment ideas to determine the best outcome. We also offer ESG-specific reporting packages that help clients with regulatory and industry reporting obligations.

Yulan: An important differentiator is the work that our servicing team does to generate a true start-of-day view across the whole fund. We provide services to many of the largest global asset managers that also count superannuation funds as their clients. By delivering a true investment book of record and exposure book of record at the start of each trading day, we help funds to make better informed decisions.

Our outsourced asset servicing, data management and governance solutions help deliver timely and accurate data to support portfolio-level analytics.

To learn more, visit:
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