Transcription of podcast with Stewart Brentnall, CIO of Tcorp

Wouter Klijn = WK
Stewart Brentnall = SB

WK: It has been an interesting time over the last few weeks. How is everyone holding up at Tcorp with the coronavirus going on?

SB: It has been an interesting time and we have almost moved into, what I call, an alternative universe. Overall people have held up very well within TCorp. We have a small and very close-knitted team at TCorp. We are all working in the same building on two floors, including HR and support services. And we have just moved to working remotely, technology has permitted that, and we have a clear operating model in the investment team and that is working well. It means we are still communicating with each other regularly on portfolios. They are doing what they are supposed to and we can continue to maintain the daily functioning of those. We've done a lot of communication with clients, who are, well, I won't say happy, but are content that things are happening daily and the portfolios are behaving as they should be.

SB: Yes, certainly. When I was in university I actually wanted to be a pilot and I had already trained as a private pilot and had my licence. My father was a commercial pilot for many years and flying fascinated me. But that was at the time of the oil shocks and joining an airline was impossible. So I decided that I would get a flexible qualification, so I became a chartered accountant. One thing led to another and I came out to Australia with Deloittes. I did some very interesting accounting investigations with Deloittes and in fact my first boss, while I was seconded to Clayton Utz, the law firm, which was doing a piece of work for CSR that related to their blue asbestos business in the 1960s, was Julie Bishop, who ran the Perth practice. I really enjoyed the forensic and analytical work which I had done as an accountant and that led me to join Schroders, as an analyst in the equities team and that is where it all started. I stayed with them for nearly 10 years, joined QIC for two years running international equities, researched European Banks with Goldman Sachs for two years and more recently did 5 years at BT, 8 years at ANZ and I've now been at TCorp for three years.

WK: Yes, and can you tell us a little bit about some of the more interesting investment projects that you got involved in before you joined TCorp?

SB: Sure, if we go back to the Schroders' days, first of all, not long after I joined we were awarded a $300 million mandate, in the 1990s that was large, from the Dutch pension fund

PGGM. It was in three parts: one was an Australian one, one was a Singaporean one and one was Hong Kong and the rest of Asia. Running that was very interesting - working with Schroder colleagues across Asia and working very closely with different parts of PGGM to really understand their portfolios and their needs.

After Schroders, I joined BT and took on the mandate of internalising their multi-manager funds with a small team, including Adrian Trollor, who works with me at TCorp now. Mutli-manager was a core part of the distribution and advice offering for BT - historically it had been run as an implemented consulting platform by Intech but BT wanted to insource that and built a solution that was more customisable for their different types of customers. It was an 18-month project to bring the funds in-house and to grow them into a $3 billion product.

I was at ANZ for eight very interesting years. I actually joined ING Australia, which ANZ had just bought, in a new CIO position, and really built a function that didn't look unlike what I had built at BT, serving all ANZ's different customer channels an adviser channel, a direct channel, a private wealth business, a Super & pension platform and an Asian business with its own investment needs. As CIO I was asked to create a central investments function, which selected external partners, ran the asset allocation, built portfolios and offered solutions out to each of those channels. Again, it was a very interesting project and business model. And it equipped me well for TCorp with the amalgamation that was needed here.

WK: Yes, you mentioned internalisation, which is very topical at the moment. I believe that within TCorp certain assets are run internally, but not all of them. Can you tell me a little bit about that?

SB: Certainly, let's take a step back. When I joined, my main mission was to bring three investment ecosystems together, the TCorp investment team, the State Super investment team and the, what is now called, icare investment team and to build a single best-practice model. Central to that is to determine what the customer mandates are and then to understand how to best deliver those. A core part of this is to determine what one's comparative advantages are and to leverage them. At Tcorp we have two - the Domestic cash and bond team, and the Real Assets team, which we inherited from State Super, who had run unlisted real estate and infrastructure assets in-house. We've continued investing in those two parts of the business, where I think we still have a comparative advantage and where we can bring highly customised and ultimately better risk-adjusted return solutions to clients. So that is a significant part of our model now and a significant part of our mission to build best practice.

WK: If we look at the investment side, TCorp has been moving away from Strategic Asset Allocation to a total portfolio approach. Why is this important?

SB: There is a basic question one needs to ask here. Each of our clients essentially has a long term investment objective. The question: How can we build an end-to-end investment philosophy, process and model that fully aligns with our customer objective. This involves a few things, which are simple to talk about but not so simple to build. Number one, a recognition that once we have agreed an investment object and risk appetite with the client the next most important thing is to understand how much risk we need to take to achieve this – but at the total portfolio, and not in the individual sectors. Secondly, we need to recognise that asset classes don't very well describe the amount or complexity of risk they bring to a portfolio and one needs to look through them to the individual securities to build a holistic picture of the complexion of risk at the total portfolio level. Thirdly, a sector approach actually brings an agency risk into the process. So as soon as you break up that customer investment objective into a proxy benchmark, an SAA, and give each of those parts a component of capital, you'll create silos and silo behaviours. You've created a set of sector benchmarks that don't have much alignment with the client's investments objective; you are actually encouraging people to do things that are not aiming for a holistically, optimal result for the client.

WK: Can you give us some practical examples of how this approach has led to changes in the portfolio?

SB: So, starting from the risk perspective, the first two steps are then to express the portfolio in a very simple, implementable version, maybe with equities, treasuries, credit and cash. And once you go from that you get a portfolio that everyone understands: our clients, the board, the investment committee and investment team. There needs to be a mission where every decision in that portfolio competes with every other decision and ultimately seeks to increase the risk adjusted returns that is delivered to the clients.
So change number one, if we look at the opportunities we don't just compare it to one sector, we compare it to everything else in the portfolio and they are compared in such a way that we iterate different opportunities and establish which are best for the portfolio in adding the most risk-adjusted returns.
The second thing, when we come back to that question around agency risk, a sector based process will seek to construct the risk in the portfolio and then select a component so that it will diversify active risk at the sector level by appointing a number of different managers in that sector. And if you multiply that by the number of sectors, you end up with a very large number of managers and don't have a particularly clear picture of the interaction between the risk and returns, the active risk and active returns of each of those managers. So the second change is that we've been able to streamline the portfolio and we have a significant smaller number of relationships, but they are more strategic in nature.

You can see from the simplistic, more holistic nature of the portfolio that it makes the implementation a little bit more straightforward. So there are operational efficiencies, investment improvements and ultimately there are people and culture improvements, because the entire team is working together to achieve the same thing and it is really a very motivating and energising model.

WK: In this new approach, you take equity risk as the starting point of assessing every investment. Is that right?

SB: Look, in asking the two questions: how much risk and what complexity of risk, when one looks at portfolios there is a reality to life: to get a return we have to take risk. So that is covered by those two questions. Equally, the reality of life, looking at the correlation of the variability of portfolios within equity…, equity risk and this is my point about looking at sectors and ultimately doing it from a bottom-up security perspective, equity risk dominates in any portfolio other than cash. And equity risk will be the primary driver of risk and return in a portfolio. So it is an extremely logical starting point to model how much equity risk we need to deliver returns and then to understand how we can diversify equity risk with other forms of risk that pay differently.

WK: You mentioned earlier that it has also driven change in the culture of the organisation. How was the new model received? Was there any push back?

SB: Yes, is the simple answer. I don't think any change will get everybody's approval at the starting line. Us humans weren't really built for change and when you look at the engagement around the process change, we are always going to have people with different styles. Bucket one are high risk appetite supporters, who absolutely get what the motive is, they get it. They support it 150 percent and they are agnostic to the discomfort that it is going to impose along the journey. The vast majority of people are bucket two, who understand the change and are inwardly supportive, but they are a little bit nervous and anxious about what it means. Nonetheless, with the appropriate engagement and support, communication and encouragement, they will come on the journey and help change to the new model. Then there are some people, who for any reason are skeptical and make the journey a little bit more difficult. But that is the reality of life, change management is never easy. Humans are probably the largest part of it and culture requires a great deal of effort, which we did at TCorp. I've been there for three years, it has been a long journey, we are not yet complete, but are we at a better place? Absolutely. We've had a difficult year, a difficult 12 months period, while we were on that journey. But that's because at the start we hadn't quite got the clarity and understanding and therefore the endorsement and support of all the different stakeholders and people that were involved in that change.

WK: The changes have resulted in a new structure, where there are seven different teams responsible for different parts of the investment process. How does this model fit with the total portfolio approach?

SB: Let’s go back to my point about agency risk. What we sought to do is change the structure so that there are teams that have absolutely clear functions, that are client oriented and are all aligned to that single client investment objective, in different ways, but mainly in KPIs. So we have the maximum probability of delivering that objective. Whether it is the client advisory team that engages with the client, does the risk appetite work with them, and agrees on the investment objective, or whether it is the portfolio construction team that is putting all the bits together, or whether it is the partner selection team that is responsible right across the sectors in a completely consistent way or in engaging and naming partners, or whether it is our stewardship implementation, they all have a very clear purpose that is aligned with what the customer is trying to do.

WK: You mentioned you look for more strategic relationships with managers. This partnership model came from the US and had a particular structure to it, but can you tell me how you define a partnership model?

SB: I look at that with a slightly simplistic lense, perhaps, and say that the best way to operate a strategic partnership is for each side to be really clear on what the motivations and contributions are. Now from our perspective, we look for partners that are able to put themselves in our shoes and to absolutely understand what the client mandates, mission and risk appetite and constraints are in order to be able to help. Again, looking at that single client investment objective. It is not always very easy for organisations to do. Firstly, they are often quite narrow and only offer certain capabilities. Secondly, they might be very large, but have historically operated on a siloed basis, rather than a customer basis. But increasingly we are finding that organisations are accepting the challenge that I’ve outlined and seeking to have relationship models which enable their clients to quickly identify and access all of their different capabilities. And for that to be able to do that in a coordinated way, so that there aren’t too many touch points and not huge numbers of people on either side of the fence.

WK: TCorp has become a very large organisation, around $100 billion. Often when organisations become this large there are practical reasons for more investments to be managed passively. What are your thoughts on the split between active and passive strategies?

SB: So, firstly, yes you are right, we are an organisation that manages around $100 bn in Australian dollars, which does present challenges that smaller organisations don’t have. We simply can not be as nimble and dynamic in moving money around asset classes. However, that

in itself is not a condition in which you would say: ‘Let’s move to passive; it is all too hard’. Our mission is to provide customers with the best risk-adjusted net of fee performance that we can. It is important to get a really clear lense on that and to combine that with the point I made on comparative advantages. It says that the starting point is something that is a relatively passive portfolio, but if we can do better than that we will go hard. In our portfolios at the moment, a very significant part of that is active and we don’t feel the imperative to save costs. That is not one of our missions and that was a very specific discussion point in the investment committee. It is not one of our aims to save cost. So we look really hard for parts of the market that are inefficient and where we feel we can enter them effectively and where we have a clear understanding of how to exit them effectively and efficiently as well. Now some of this actually involves sourcing assets in an advantaged way from our peer group.

I’ll give you an example. We source assets from, in several cases, our Canadian peers, where both sides have decided they prefer not to go through public auctions, they agree a price upfront, and they agree a partnership horizon upfront and we’ve done deals at a very acceptable price, which has enabled us to access active return on opportunities that have already been very good for clients.

WK: Talking about the Canadians, what is your view on the Canadian model? It is very interesting to see that in the last 10 years, this model which focuses heavily on unlisted assets and internalisation of investment management, has done very well. But it is a relatively expensive model and going forward, where returns will be lower, it might not do so well. What are your thoughts on this?

SB: The Canadians have a very interesting model. There are three things that they collectively do, which makes the model. Number one, the board is completely independent of their sponsor governments. Number two, the ability for that board to hire whatever staff they want. And number three, for that board then to delegate heavily to that staff, to the executive team. Now that is very virtuous, it is also a gift from government and they can take that back any time. It overlooks one thing that is quite different at Tcorp. TCorp is a rather unique organisation in that it has both the debt issuer and the investment management wing under one roof. We are at a position for those two capabilities to be an enormous help to government, provided that we stay quite close to them. So we are differentiated in operating not quite independently from government but to stay intentionally quite close to them. We’ve got a very competent team that I was allowed to hire and thankfully very early in the game we agreed with the board that we do need to delegate quite heavily to the investment team. It is interesting that boards meet 4 to 6 times a year, discuss investments for 30 - 45 minutes each time and therefore only talk about investment for 2 - 3 hours a year. And our board with wonderful foresight said: ‘Given that, we want the key decisions to be taken by experts and won’t be unnecessarily be held up by

governance hurdles and constraints. And that has worked really well for us. It has worked for the Canadians as well.

I think unlisted assets are something that should be particular to clients that have the right horizon and the right risk appetite for that. Subject to those two, it has been a very successful strategy. In fact, there is no reason why it shouldn't continue.

Internalising is something that I think organisations should be very careful of in a governance sense, because a board should treat an internal team exactly as it would treat external teams, mainly if something goes wrong or if a process changes or ceases to be suitable for market conditions in a structural or strategic way, the board should be willing to terminate that team. Internalising brings forward a new agency risk, principal agency risk comes inside the organisation, because the larger the internal capability gets, the more difficult it gets to fire it in times of underperformance. And there are pockets in the Canadian industry that are finding this, I believe, quite challenging.

But look at the end of the day, this model has stood in great stead. It has delivered, for the amount of risk in the portfolio, better returns than in the rest of the world. And we feel at TCorp that we are able to pick the best parts of that model, without simply replicating the whole lot.

WK: We started off with talking about the coronavirus, but if we draw this more broadly, how well is TCorp positioned to deal with drawdowns in the market like this?

SB: I'm extremely fortunate here in having both a great board, who delegates to us, they put in place a board investment committee, which in itself has few rights, but it has critical functions in that it has oversight on behalf of the board and also strategic engagement with executive. The board committee is a set of highly experienced and very talented individuals. When we have strategic engagement with them it is not always comfortable, it can be quite challenging, but we have benefited enormously from that process. The work we have done with clients on risk appetite and risk appetite statements, which has been a very deep engaged piece of work, is paying off huge dividends. And although clients aren't happy in the current situation, they are very content with how their portfolios are set up for their purpose and risk appetite and they are doing what they are supposed to do, notwithstanding the drawdowns. So we spend a lot of time with clients, who have long horizons and high risk appetites, saying: 'You have a portfolio which is going to deliver what you need in the long term. It will be subject to pain in the short term, but it is designed well and it can live through that. It will deliver in the long term.

Now we are the data points for this? Number one, we are having a lot of communication with clients, which reflects their comfort. Number two, there is plenty of liquidity in all of our portfolios,

as per design, to enable them to continue operating. Number three, can we transact and do what we need to do on a daily basis? Yes. And that is basically rebalancing, foreign exchange coverage, basic hedging and tail risk hedging for a small number of portfolios which are particularly sensitive to the downside. And because we have the right operating model and because we have adequate liquidity in the portfolio we can do all of that.

We are in a very fortunate position that not all of our portfolios are in superannuation and so we have greater certainty of cash flows and are not subject to exogenous customer choices.

WK: So having implemented the new model, is it all done and dusted?

SB: No, it is absolutely not done and dusted. This is an ongoing journey that will have many different aspects to it. If I go back to the beginning of this project, we quickly became aware tht this wasn't a single project. It was in fact a four-part project. One was changing the governance, the business model, which we did up front. The second was changing the investment model, which is ongoing. We are well-advanced with that now. The third one was the people and culture model, so we needed to change the organisation and the structure to get the new model working. And we also needed to go on a very interesting culture journey to understand the differences with the sector model. And the fourth one is an operating model change where information and ability to access that information under a TPA model was fundamentally different from what we previously had. We historically relied very heavily on custody information and then there were some spreadsheets above that. But we've now installed, this was only seven days ago, the BlackRock Aladdin system, which basically enters every single investment that we own, generates a very enriched set of data, which we can cut and dice in any way we want, reflects the portfolio in different ways and at different levels, but also allows us to analyse risk in a forward looking sense and see the complexity that we have in portfolios. Now these things are but young. While the governance has been implemented before, the investment, the people model and operating model still have a long way to go. We are walking together with our clients down that journey and in my view it is a never ending journey. We have done most of the heavy lifting, but there is still a great deal of refining to do.

WK: Well, thank you very much Stewart, this has been a very interesting discussion.

SB: Thank you.