



The AMBACHTSHEER Letter

Sustainable Pension Design • Effective Pension Management

May 2024

THE TOTAL PORTFOLIO APPROACH TO INSTITUTIONAL INVESTING:

FACT OR FICTION?

“The Chartered Alternative Investment Association (CAIA) is endorsing a new Total Portfolio Approach (TPA) to institutional investing. It eschews asset class benchmarks in favor of total portfolio outcomes, a tact proponents say could take a generation to implement.”

CIO Magazine
March 22, 2024

“TPA eschews the traditional concepts of asset allocation and passive benchmarks in favor of picking the best investment ideas for the portfolio designed to meet a total return goal consistent with the Fund’s actual purpose. It is a unified means of assessing risk and return of the total portfolio.”

Pensions & Investments
April 1, 2024

“We have become firmly anchored in Modern Portfolio Theory (MPT) since its introduction in the early 1950s. Its most tangible heir is Strategic Asset Allocation (SAA). All its apparatus – mean-variance optimization, efficient frontier, benchmarking....not to mention organizational charts, compensation structures, academic course work, the consulting industry, and performance reporting have perpetuated this world view.....In recent years, however, an enterprising handful of large institutional asset owners have begun challenging the common wisdom of an SAA approach....a new approach has emerged..... we refer to it as the Total Portfolio Approach (TPA).”

John Bowman, President
CAIA Association

Has A New Approach Really Emerged?

So what is this new *Total Portfolio Approach* and will it really replace the old *Strategic Asset Allocation* approach? That is the question this *Letter* addresses. Let’s start with what the cited *CIO* and *P&I* articles have to say about it:

- “TPA is a unified means of assessing risk and return of the whole portfolio.”
- “TPA is not a specific model with a singular destination. Rather, it comprises a range of approaches that can be tailored to each asset owner in order to design a portfolio that best represents the team’s long term investment thesis.”
- “While SAA seeks to outperform benchmarks, TPA focuses on the Fund’s absolute return goals.”
- “While SAA seeks diversification through asset classes, TPA achieves it through control of various risk factors.”

- “While SAA-centric organizations implement investment decisions by multiple teams competing for capital, in TPA there is just one team collaborating together on decision-making.”
- “While the Board dominates portfolio construction under the SAA model, the Chief Investment Officer is much more empowered in the TPA approach.”
- “TPA is the ‘next realm’ of portfolio construction, succeeding the *Yale*, *Canadian*, and *Norwegian Models*, which are based on the SAA construct with fixed target asset allocations.”

Stating the obvious, these TPA explanations taken from the CIO and P&I articles are not very helpful. Fortunately, the CAIA Association has produced a 38-page booklet titled: “[Innovation Unleashed: The Rise of Total Portfolio Approach](#)”. Let’s see what it has to say.

Innovation Unleashed?

In its opening chapter, CAIA President John Bowman asserts:

- “The weaknesses of SAA include silo behavior, unhealthy competition for resources, and difficulty managing the capital pool holistically around a view of the future.”
- “The CAIA Association’s ethos has been to press the institutional investment industry forward....as such, we believe TPA deserves the mobilizing oxygen that CAIA’s global convening power can provide to a transformative topic.”
- “TPA is not a monolithic methodology that can be applied off the shelf. It has both hard and soft elements that create a spectrum of process variations. It is more a state of mind than a policy or a process.”

To illustrate these points, CAIA invited contributions on four aspects of TPA: from *Australia’s Future Fund* on governance, from *Canada’s CPP Investments* on risk measurement and management, from *New Zealand’s NZ Super* on competition for capital, and from *Singapore’s GIC* on organization culture. Here are summaries of these four contributions:

- TPA and governance: “Any investment opportunity must stack up against other opportunities and existing portfolio exposures. Because the investment objective isn’t divided into multiple smaller asset class objectives, the Board will, by necessity, be more involved in investment decisions than where the SAA approach is applied.”
- TPA and risk measurement/management: “Diversification is the most powerful lever to control risk and long-term returns at the total fund level. At the heart of TPA is looking at assets through a factor lens. This means factors like economic growth, interest rates, credit spreads, and currencies which bring clarity to the portfolio’s underlying risk-return drivers. In our framework, this involves setting risk targets, and determining the mix of factor exposures that is robust to different macroeconomic environments. This includes both climate change and geopolitical considerations. From there, the process leads to a more detailed set of strategy implementation targets, including employing active management in both public and private markets.”
- TPA and competition for capital: “Ideally, each investment should earn its way into the portfolio. This aligns well with the fundamental MPT idea which places the portfolio rather than its constituents at the centre of investment decision-making. In practice, this is not an easy thing to do. We can’t be constantly re-solving for the optimal portfolio in real time.”

The application of *TPA* requires a flexible approach to portfolio construction over time within the constraints of our active and liquidity risk budgets, and also within our human capital constraints.”

- *TPA* and organization culture: “The successful implementation of *TPA* requires an organization culture built on long-termism and agility, with all employees sharing one clear focus: to deliver good real returns for the total portfolio over the long-term. For example, *GIC*’s key performance metric from its client is a 20-year rolling real rate of return. At the same time, agility is also a key success attribute. This means organizing regular cross-department forums to facilitate the sharing of ideas and rationale of enterprise strategies. It is a never-ending journey.”

What are we to make of all this? Does the *Total Portfolio Approach* really represent the radically new approach the institutional investing suggested by the *CAIA Association*? Or does it represent the logical evolution of leading-edge institutional investing practices in the 21st Century? *TPA* is certainly fact, but do its origins truly represent “innovation unleashed” as characterized in the *CAIA* document? Or is that part of the story more fiction than fact? In other words, is there a less dramatic, more facts-based way to tell the story?

The Real Origins of *TPA*

Two historical events combined to eventually trigger the *Total Portfolio Approach* to institutional investing:

1. The 1952 publication of Harry Markowitz’s paper “Portfolio Selection” which provided a conceptual framework for turning lists of individual investment opportunities into ‘optimal’ portfolios which maximized the ratio of expected return per unit of return volatility along an ‘efficient frontier’ of portfolios from lowest risk to increasingly higher risk levels.
2. The 1976 publication of Peter Drucker’s book “The Unseen Revolution” which provided a conceptual framework for creating effective pension organizations to manage the \$trillions retirement savings for billions of retired workers in the coming decades.

The Markowitz paper has triggered many iterations and adaptations since its publication 72 years ago. One of the more important ones is the *Total Portfolio Approach*, as described by the four institutional investor contributors to the *CAIA* document. Among the factors they mentioned requiring adaptation were time-horizon (i.e., long), types of prospective investment assets (e.g., public, private), risk exposure proxies (e.g., liquidity, economic factors, climate, geopolitical).

The Drucker book triggered the creation of the admired Canadian Pension Model in 1990, with *Ontario Teachers’ Pension Plan* its first manifestation. The three key features of the Model are 1. Independent/Arms-Length legal structure, 2. Fiduciary/Expert Governance, and 3. Insourcing the Investment Function. Not surprisingly, all four organizations cited in the *CAIA* document are endowed with these three features.

Where To From Here?

The *Ambachtsheer Letter* regularly addresses the ‘where to from here?’ question in the context of the *Total Portfolio Approach*. Here are six recent examples:

- [Jan 2023](#) “**Governance and the *Interdependent Instability Era*: Is It Up To The Task?**” *The world is becoming an increasingly complex place, placing greater demands on the governance functions of pension organizations and of the organizations they invest in. Tools like Bartley Madden’s Pragmatic Theory of the Firm and more rigorous Board selection processes are becoming increasingly necessary.*

- [Sep 2023](#) **“Climate Models Built By Economists: Are They Materially Underestimating Climate Change-Related Risks?”** *Two new papers, released within days of each other, both claim that the models being used to assess the potential impact of climate change on the economy and financial markets grossly underestimate the potential size of these impacts. Ignoring this possibility constitutes a clear breach of fiduciary duty.*
- [Nov 2023](#) **“Peter Drucker’s Pension Revolution in Action: How ‘Canadian Pension Model’ Organizations Use Private Markers To Create Value”** *A new study documents efforts by Canadian pension organizations towards direct involvement in value-creation processes. Case studies range from retail real estate across Canada, to a private loan platform in the USA, to a farming conglomerate in Hawaii, to a regional transportation system in Quebec.*
- [Jan 2024](#) **“Improving Investment Models For Pension Funds: How Are We Doing?”** *Investment models have evolved considerably since the 1950s. Andrew Lo argued investment models need to be adaptive, sensitive changing investment environments. Profs. Kay and King argued for the need to distinguish quantifiable risks and broad radical uncertainties not subject to quantification. The Letter shows how to integrate these ideas into investment decision-making processes.*
- [Feb 2024](#) **“Thoughts On Building An Effective Governance Function: Two Differing Points Of View”** *This Letter contrasts the description of pension fund governance offered by two Dutch pension professionals with what can be deduced as the ideal governance function from first principles. The former approach is quite ‘hands on’, with pension Boards actively participating in managing the fund. In the latter approach, the Board an oversight role, ensuring that the key organizational success drivers (e.g., clear purpose, strong management, viable strategic plan, effective implementation tools) are all in place.*
- [Mar 2024](#) **“Travelling The Road To Pension Fund Capitalism: A Progress Report”** *Once again, this Letter returns to Drucker’s vision of workers owning the means of production through their retirement savings, and Madden’s pragmatic theory of the firm that flows from vision, to efficiency gains, to win-win relationships, to value-creation today and tomorrow. Specifically, the Letter describes CPP Investments’ Portfolio Value Creation (PVC) innovation. The PVC Group has a mandate to create measurable value, working both inside CPP Investments, and outside, with investee organizations.*

We encourage you to give these six *Letters* a more detailed read. Each provides links to further research findings related to the development and implementation of *TPA*.

A Final Observation

It’s great to see the *CAIA Association* endorsing *TPA* as ‘the better way’. However, as already noted above, it is not a simple matter of pensions and other fiduciary organizations making the *TPA* adoption decision. A successful *TPA* transition requires three elements: 1. Independent/Arms-Length legal structure, 2. Fiduciary/Expert Governance, and 3. Insourcing the Investment Function. Taken together, such a transition amounts to a fundamental restructuring of the pension/investment organization. They happen infrequently, and when they do, take many years to bring to a successful completion.

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Published by KPA Advisory Services Ltd., 1 Bedford Road, Suite 2802, Toronto ON Canada M5R 2B5
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