McKinsey&Company

McKinsey on Investing

Number 1, Winter 2014/15

5
The $64 trillion question: Convergence in asset management

12
A conversation with Edward Bonham Carter of Jupiter Asset Management

17
An interview with Douglas Hodge of PIMCO

23
Changing perceptions and new realities in private equity

30
A conversation with Jim Coulter of TPG

36
Money isn't everything (but we need $57 trillion for infrastructure)

40
Private equity in India: Once overestimated, now underserved

51
From indexes to insights: The rise of thematic investing

57
What overachieving institutional investors get right

61
Investing for the long term

68
Uncovering hidden investment opportunities in Africa

70
Private-equity operations: Inside the black box

McKinsey on Investing is written by experts and practitioners in McKinsey's global investor-focused practices, including our Private Equity & Principal Investors, Wealth & Asset Management, and Infrastructure Practices.

To send comments or request copies, e-mail us: Investing@McKinsey.com

Special thanks to Ethan Ard, Jennifer Arnold, Nick Bawa, John Gwin, Wendy Lee, and Jenny Wong for their contributions to this volume.

Editor: Mark Staples
Art Direction and Design: Leff Communications
Managing Editors: Michael T. Borruso, Venetia Simcock
Editorial Production: Runa Arora, Elizabeth Brown, Heather Byer, Torea Frey, Shahnaz Islam, Katya Petriwsky, John C. Sanchez, Sneha Vats

Cover illustration by Jon Krause

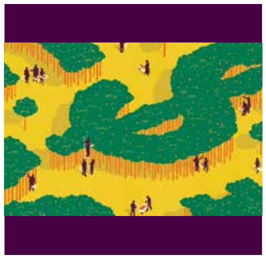
McKinsey Practice Publications
Editor-in-Chief: Lucia Rahilly
Executive Editors: Allan Gold, Bill Javetski, Mark Staples

McKinsey on Investing

Number 1, Winter 2014/15

2
Introduction

Asset management



5
The $64 trillion question: Convergence in asset management

Traditional asset managers and alternatives specialists are eagerly contending for an outsize share of a rapidly growing industry.

12
A new era for asset management: A conversation with Edward Bonham Carter

A leading manager shares his views on an industry undergoing profound change.

17
Thriving in a world of low and flat: An interview with Douglas Hodge

The head of the world's largest fixed-income manager discusses the industry's past, present, and future.

Alternative asset management

23
Changing perceptions and new realities in private equity

Industry performance is better than previously thought, but success is getting harder to repeat. Investors and firms will need to adapt to changing conditions.

30
A conversation with Jim Coulter

The veteran investor discusses alternative assets, shifting currents within the industry, and how management fees are like a two-by-four.

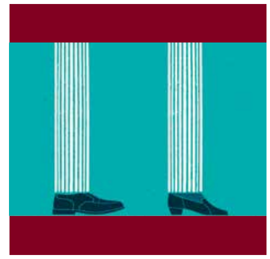
36
Money isn't everything (but we need $57 trillion for infrastructure)

A massive funding gap will open in coming years. New research shows how to close part of it.

40
Private equity in India: Once overestimated, now underserved

General partners can use lessons from the past decade to build a new and better future.

Institutional investing



51
From indexes to insights: The rise of thematic investing

Leading institutions say this new approach can deliver better performance over the long term than their traditional methods. Here's how they're putting it in place.

57
What overachieving institutional investors get right

No single practice or behavior explains success. Instead, top investors work across five dimensions to achieve excellence.

61
Investing for the long term

Dominic Barton, McKinsey's global managing director, and Mark Wiseman, president and CEO of Canada's largest pension fund, explain why big investors are crucial to ending the plague of short-termism.

Research in brief

68
Uncovering hidden investment opportunities in Africa

Recent research on the African private-equity market reveals a mismatch between supply and demand for financing that could point to investment opportunities.

70
Private-equity operations: Inside the black box

Initiatives to accelerate growth are a priority; cost cutting is seen as a commodity skill.

Introduction

Welcome to the inaugural issue of *McKinsey on Investing*, created to share new ideas about the business of investing with professional asset managers and institutional investors. We have conferred with colleagues in our offices around the world to assemble the best of our recent research and thinking. And we have been fortunate to speak with three leading voices: Edward Bonham Carter of Jupiter Asset Management, Jim Coulter of TPG, and Douglas Hodge of PIMCO. We hope that this combination of perspectives will spark ideas and advance dialogue on the industry.

Investing matters. About 40 percent of the world's capital, some $64 trillion, is under professional management, and that number is growing fast as financial markets mature around the world. *McKinsey on Investing* is intended to capture our perspectives on this industry. Our focus thus extends from institutional investors—pension funds, sovereign-wealth firms, endowments, family offices, and others—to the diverse entities that have arisen to serve these institutions, including both traditional asset-management firms and managers of "alternative investments" (a moniker that's more ubiquitous than accurate today). Within alternatives, we consider the increasingly overlapping realms of private equity, hedge funds, infrastructure, real estate, and other asset classes beyond stocks and bonds.

The lines that have historically separated these worlds—general partner and limited partner, traditional and alternative, institutional and retail—are rapidly blurring. Limited partners are investing directly. Asset managers are entering alternatives, while private-equity firms and hedge funds are eyeing the infrastructure, retail customer base, and public-market multiples of the asset-management giants. Retail investors are moving into asset classes and investment vehicles traditionally restricted to institutions. And so on. The people, tools, and approaches we deploy in advising each of these types of players are intersecting more and more. It is only natural that we share our perspectives on these converging worlds in an integrated manner.

Old habits die hard, however, so for simplicity we have grouped these articles in four traditional categories. First, we present three points of view on *asset management*. We then offer a variety of perspectives on *alternative asset management*, the fastest-growing corner of the industry. Three articles detailing the pursuit of excellence and long-term objectives in *institutional investing* follow. We conclude with *quick research summaries* of two recent efforts in the private-equity space.

We hope you enjoy these articles and find in them ideas worthy of your consideration. Let us know if we're hitting the target—or if we're wide of the mark. You can also view these articles and many others at mckinsey.com.

Bryce Klempner

Bryce Klempner

Asset management

Neil Webb

5
The $64 trillion question: Convergence in asset management
Pooneh Baghai, Onur Erzan, and Ju-Hon Kwek

12
A new era for asset management: A conversation with Edward Bonham Carter
Martin Huber

17
Thriving in a world of low and flat: An interview with Douglas Hodge
Martin Huber

The $64 trillion question: Convergence in asset management

Traditional asset managers and alternatives specialists are eagerly contending for an outsize share of a rapidly growing industry.

Pooneh Baghai,
Onur Erzan,
and Ju-Hon Kwek

The boom in alternative investments presents something of a paradox. On one hand, money has continued to pour into alternatives over the past three years. Assets hit a record high of $7.2 trillion in 2013.[1] The category has now doubled in size since 2005, with global assets under management (AUM) growing at an annualized pace of 10.7 percent—twice the rate of traditional investments (Exhibit 1). New flows into alternatives were 6 percent of total assets in 2013, dwarfing the 1 to 2 percent rate of nonalternatives. Every alternative asset grew, especially direct hedge funds, real assets, and retail alternatives sold through registered vehicles like mutual funds and exchange-traded funds (ETFs). Even private equity, where assets retreated from pre-crisis highs, has bounced back in its new fund-raising.

Curiously, though, alternatives have enjoyed this growth at a time when their returns have generally lagged behind the broader market indexes. The average hedge fund, for instance, produced an 11 percent return in 2013, while the S&P 500 index soared by 30 percent. Skeptics contend that if returns stay sluggish, investor patience will wear thin, and the alternatives boom will run out of steam. However, our new research clearly indicates that the boom is far from over. In fact, it has much more room to run. In late 2013 and early 2014, we surveyed nearly 300 institutional investors managing $2.7 trillion in total assets and conducted more than 50 interviews with a cross section of investors by size and type. The vast majority of institutional investors intend to either maintain or increase their allocations to alternatives over the next three years. Interest is especially keen among large and small pension funds (though not midsize funds) and sovereign-wealth funds. Wealthy individuals are also moving rapidly into the market, as new product vehicles provide unprecedented access to retail investors. Flows from each of these four groups could grow by more than 10 percent annually over the next five years.

In this article, we will first explore the factors driving growth. We then review the two big trends that should shape the strategy of any firm seeking to expand in alternatives: the growing bifurcation of the investor base and some complex shifts in competitive dynamics within the industry.

Structural, not cyclical

The rush into alternatives is not a momentum trade. Our interviews with institutional investors suggest that four secular factors are at work:

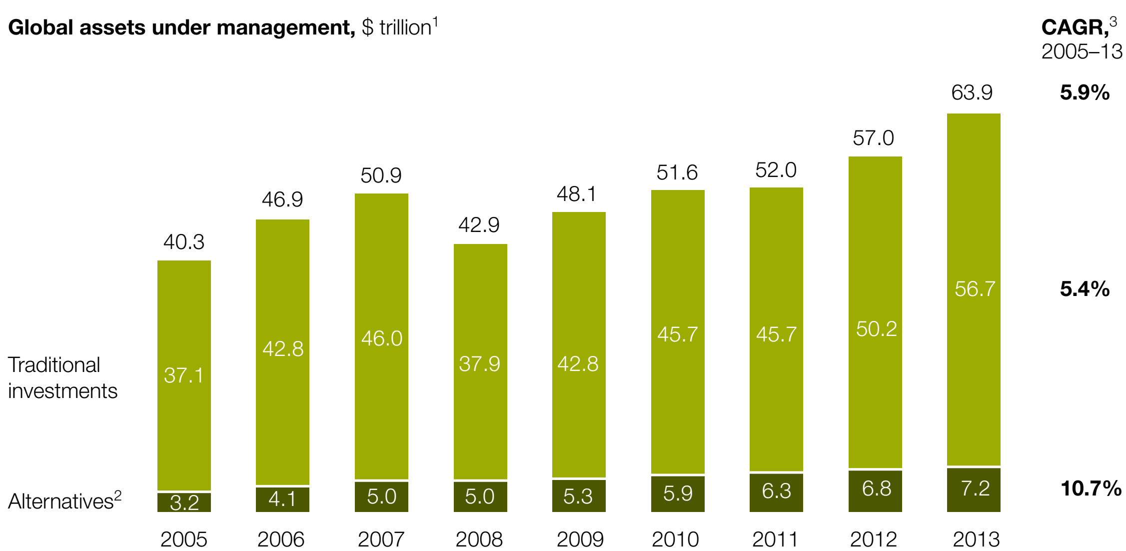
- Disillusionment with traditional asset classes and products. An increasing number of investors are now using alternatives (particularly hedge funds) as a way to dampen portfolio volatility and generate a steady stream of returns. Demand for alternative credit products has been particularly strong, driven by challenges posed to long-only strategies in the current low (but highly uncertain) rate environment.

- Evolution in state-of-the-art portfolio construction. Many investors seek to complement the low-cost beta achieved through index strategies with the "diversified alpha" and "exotic beta" of alternatives. Further, some of the most sophisticated institutions are beginning to abandon traditional asset-class definitions and embrace risk factor–based methodologies, a trend that repositions alternatives from a niche allocation to a central part of the portfolio (for more, see "From indexes to insights: The rise of thematic investing," on page 51).

- Increased focus on specific investment outcomes. The shift from relative return

Exhibit 1

Alternative investments have grown twice as fast as traditional investments since 2005.



[1]Figures may not sum, because of rounding.
[2]Does not include retail alternatives (ie, exchange-traded funds, mutual funds, and registered closed-end funds).
[3]Compound annual growth rate.

Source: Hedge Fund Research; Preqin; McKinsey analysis benchmarks to concrete outcomes tied to specific investor needs has created a new tailwind for alternatives. Alternative strategies are seen as more precise tools—for example, real estate and infrastructure can provide inflation-protected income, and hedge funds can help manage volatility.

- A hard-to-close gap. Some defined-benefit pension plans have persistent asset-liability gaps and are assuming unrealistic rates of return in the range of 7 to 8 percent. Many of these plan sponsors are placing their faith in higher-yielding alternatives.

Other McKinsey research finds that the retail segment will be a primary driver of alternatives growth, particularly in the United States. High-net-worth individuals and the mass affluent are increasingly looking to hedge downside risk, protect principal, manage volatility, and generate income. Access to alternative strategies is being democratized through product and packaging innovations within regulated mutual funds and ETFs. As a result, the broad category of retail alternatives assets—which includes alternative-like strategies such as commodities, long-short products and market-neutral strategies in mutual fund, closed-end fund, and ETF formats—has grown by 16 percent annually since 2005 and now stands at almost $900 billion. Hedge-fund-like offerings structured as so-called '40 Act funds[2] have experienced particularly robust growth, as investors seek to balance their desire for new alternatives exposures with the need for liquidity.

The upshot is that alternatives now account for a disproportionate share of industry revenues, a state of affairs that we expect will continue. In 2013, alternatives accounted for about 12 percent of global industry assets but generated one-third of revenues. By 2020, alternatives will comprise about 15 percent of global industry assets and produce up to 40 percent of industry revenues, as the category continues to siphon flows from traditional products.

Moreover, alternatives' fees are holding up better than many expected—a sharp contrast to traditional actively managed products, which face the growing threat of commoditization and margin compression. Eighty percent of institutional investors we surveyed expect the management fees they pay hedge funds over the next three years will either remain at current levels or, in a small number of cases, increase. And few expect performance fees to fall, though about half expect to see structural changes to improve incentive alignment between managers and their investors. For example, many expect a move from simple high-water marks to a greater use of clawbacks. Healthy revenue yields have also held up in the retail segment. Compared with the two other major product-growth opportunities in retail asset management, ETFs and target-date funds, alternatives command a significantly higher revenue margin—more than two times greater than target-date funds and four times greater than ETFs.

A wide range of needs

As they assess the opportunity, asset managers must recognize the diversity of investment priorities and needs among client segments. Larger investors and their smaller peers are interested in adding hedge funds but otherwise have divergent product preferences (Exhibit 2).

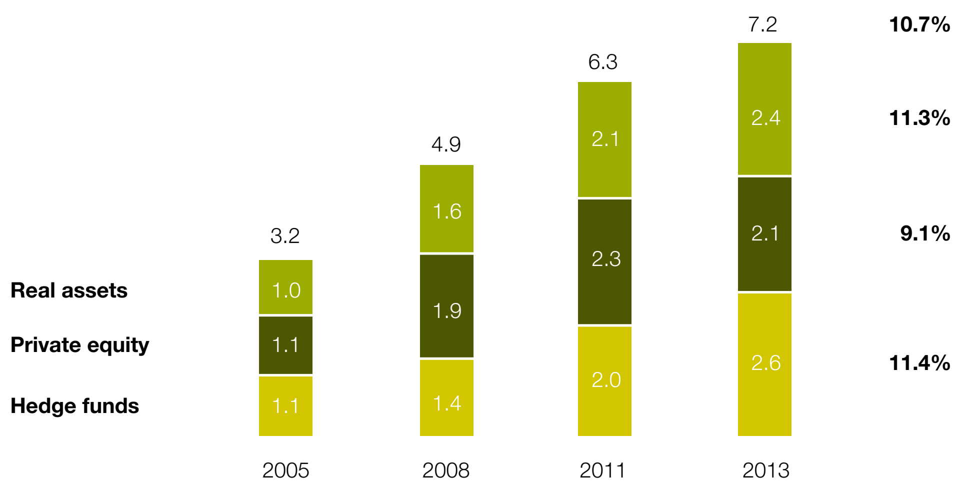
Institutions managing more than $2 billion are moving down the liquidity spectrum to embrace more specialized private-market exposures, especially to real assets. Two-thirds of these investors report that they plan to increase allocations

Exhibit 2

Growth has been broad based across alternative asset classes, with direct hedge funds and retail alternatives accelerating fastest.

Global assets under management of key alternative asset classes, $ trillion[1]

CAGR,[3] 2005–13



	2005	2008	2011	2013	CAGR, 2005–13
Fund of funds	0.5	0.8	0.9	0.9	**5.6%**
Retail alternatives[2]	0.8	1.1	1.7	2.0	**12.6%**

[1]Figures may not sum, because of rounding.
[2]Vehicles providing nonaccredited investors with exposure to alternative strategies via registered vehicles: closed-end funds, exchange-traded funds, and mutual funds.
[3]Compound annual growth rate.

Source: Hedge Fund Research; Preqin; McKinsey analysis

to agriculture, energy, infrastructure, real estate, and timber; they seek to move beyond relative investment performance toward more defined investment outcomes and extract liquidity premiums while gaining exposure to hard-to-access forms of beta. More specifically, large public pensions have come to see alternatives as critical "outcome oriented" building blocks for their portfolio (for example, as infrastructure for long-dated income, and private equity to extract illiquidity premiums). Smaller investors (those with less than $2 billion in AUM, invested by small teams of generalists) say they seek the enhanced performance and diversification that alternatives can potentially deliver (for example, unconstrained bond strategies as a replacement for core fixed-income holdings). Smaller pension plans are contemplating a shift to the "endowment model" of more aggressive and direct allocations to alternatives (versus the historic emphasis on traditional asset classes or allocations via funds of funds). Investors are also diverging in their investment priorities and manager preferences (Exhibit 3). Large investors that we surveyed indicated a desire to take greater control over their alternative investing activities. These institutions prioritize the sourcing of coinvestments and often seek to consolidate their relationships with investment managers into a smaller and more strategic set; often, they also seek assistance in building capabilities. These large, sophisticated institutions are becoming more differentiated, frequently leaning toward specialist boutiques (rather than large, generalist managers) for their ability to deliver unique capabilities and customized exposures, often in the form of separate accounts.

At the other end of the spectrum, smaller, less established investors report that their highest priority is to secure access to quality investments and managers. Alternatives add a level of complexity to the investment and risk-management processes, driving these institutions' appetite for outsourced services and solutions with embedded advice, including multialternative products, funds of funds, and managed account platforms. In contrast to their larger peers, smaller investors are drawn to large managers because of their established brands, ability to deliver across a broad range of alternative asset classes, and their robust operational and compliance infrastructures.

Exhibit 3

There is a distinct and divergent set of needs emerging among large and small investor segments.

	Large (and sophisticated) institutions	Smaller institutions
Investment priorities	Coinvestments and capability building as a favored source of value add	Access to broad range of quality managers with sound risk-management practices
Insourcing vs outsourcing	Targeted buildup of in-house investment capabilities and openness to strategic partnerships	Outsourced services valued as a supplement to internal capabilities (eg, outsourced chief investment officer and fund-of-funds models)
Investment vehicles	Separate accounts and customized structures (eg, "fund of one") preferred	Commingled and retail vehicles (mutual funds and exchange-traded funds) under active consideration
Manager preferences	Some degree of bias toward specialist managers for unique abilities and exposures	Large managers viewed positively given product breadth and perception of stability

Source: McKinsey analysis

When worlds collide

The competitive landscape in alternatives is still largely unformed. In stark contrast to traditional asset management, the alternatives market remains highly fragmented, with ample room for new category leaders to emerge (Exhibit 4). Within the hedge-fund and private-equity asset classes, for instance, the top five firms by global assets collectively captured less than 10 percent market share in 2012—a far cry from the 50 percent share enjoyed by the top five firms competing in traditional fixed-income and large-cap equity.

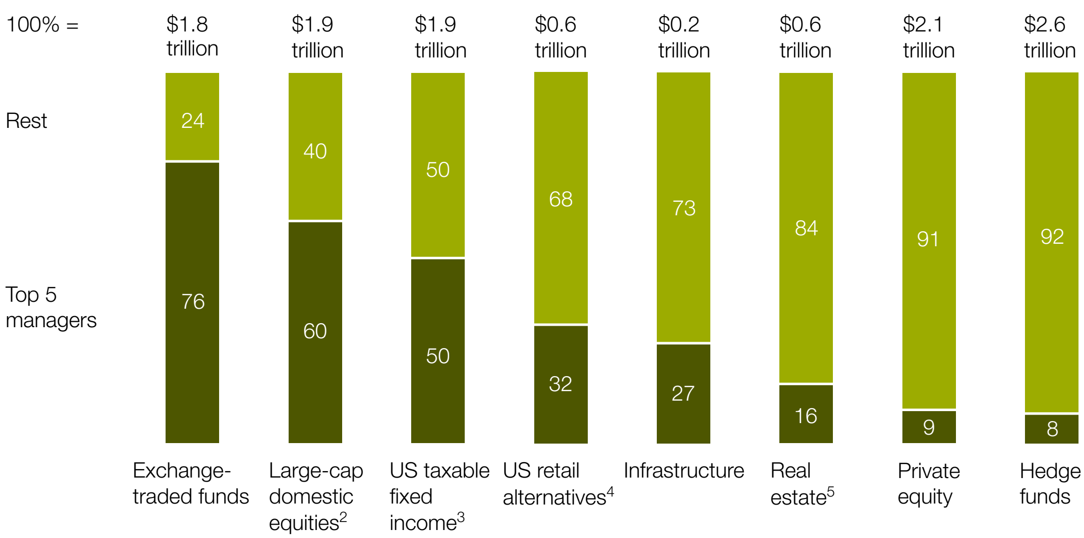
To be sure, the alternatives market will likely remain highly competitive and support a greater diversity of players than the traditional asset-management market, given some of the natural constraints on firm size (for example, the capacity limitations of certain alternative investment strategies) and the common preference for specialist boutiques. Nonetheless, some consolidation is likely as firms joust for a disproportionate share of flows.

Increasingly, that competition will not take place simply between classic rivals. The mainstreaming

Exhibit 4

The alternatives market remains highly fragmented, with ample room for new category leaders to emerge.

Concentration of alternative assets under management by top 5 managers,[1]
2013, total global assets, %



[1]Based on manager assets under management.
[2]Includes large-cap value, growth, and blend categories.
[3]Includes short-term, intermediate-term, long-term, multisector, high-yield, bank-loan, and retirement-income categories.
[4]Alternatives investment strategies in Investment Company Act of 1940 funds; excluding real-estate-investment-trust and precious-metal funds.
[5]Real-estate funds in private equity–style structures.

Source: *Institutional Investor*; Morningstar; Preqin; Strategic Insight; McKinsey analysis of alternatives is now driving a convergence of traditional and alternative asset management—two big players in the $64 trillion wealth-management industry. The two sides will increasingly battle for an overlapping set of client and product opportunities in the growing alternatives market.

Traditional asset managers have used their distribution reach to achieve a first-mover advantage in the market for alternatives mutual funds and ETFs. Indeed, 18 of the 20 largest retail alternatives funds in 2013 were run by traditional asset managers. Alternatives specialists are also moving swiftly. A few publicly listed megafirms have broken away from the pack with an aggressive expansion of their investment platforms to offer a broad and comprehensive alternatives menu across all asset classes, geographies, and strategies, including a push into retail. And some private-equity firms are acquiring market-driven, trading-related investment capabilities.

With the stakes so high, competition between traditional managers and alternatives specialists will only intensify. As alternative investments continue to make their way into retail distribution channels through vehicles such as liquid-alternatives funds, asset managers are likely to increase the pace of acquisitions and "lift outs" to add that capability. Likewise, institutional managers are acquiring capabilities in asset classes like real estate, credit, and hedge funds.

A wave of partnerships or joint ventures between traditional and alternatives firms (including funds of funds) is also possible, as smaller managers lacking scale and distribution heft seek to establish relevance in alternatives.

• • •

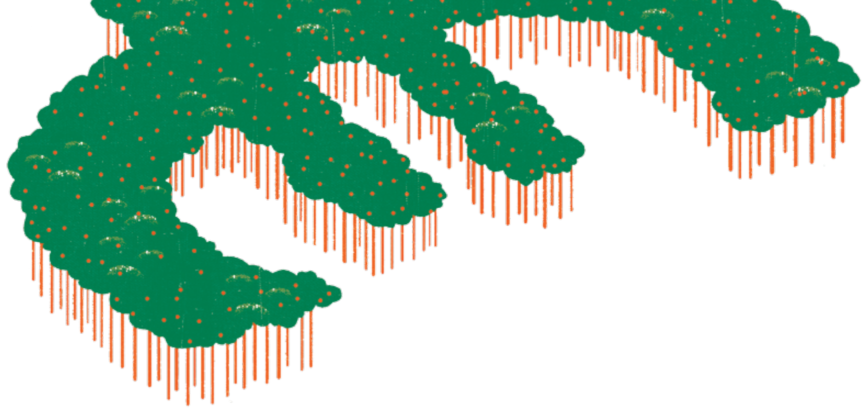
As firms consider how best to establish an advantaged position in this burgeoning industry, they need to make deliberate choices about their business model. Its design must be shaped by a clear view of the specific kinds of clients they want to serve. Several skills will increasingly be at a premium: innovation in solution-based products (such as multialternative funds), distribution (for example, liquid alternatives in defined contribution), marketing (retail advisor education on alternatives "use cases" is one example) and thought leadership (such as alternatives-oriented model portfolios). As firms get larger, their organizational challenges will naturally grow; listed companies will also have to negotiate the tricky balances between the needs of shareholders and clients. And the growth of alternatives will only exacerbate the industry's need to attract and retain top-flight talent.

[1] We include assets held by hedge funds, private-equity firms, and real assets (in agriculture, commodities, energy, infrastructure, and real estate) held by financial investors.

[2] The Investment Company Act of 1940.

The authors wish to thank Kevin Cho, Céline Dufétel, Sacha Ghai, Aly Jeddy, Owen Jones, Bryce Klempner, Carrie McCabe, Gary Pinkus, and Nancy Szmolyan for their contributions to this article.

Pooneh Baghai (Pooneh_Baghai@McKinsey.com) is a director in McKinsey's Toronto office, and **Onur Erzan** (Onur_Erzan@McKinsey.com) is a director in the New York office, where **Ju-Hon Kwek** (Ju-Hon_Kwek@McKinsey.com) is a principal. Elements of this article were adapted from the authors' report, *The trillion-dollar convergence: Capturing the next wave of growth in alternative investments*.



A new era for asset management:
A conversation with Edward Bonham Carter

A leading manager shares his views on an industry undergoing profound change.

Martin Huber

Edward Bonham Carter, vice chairman of Jupiter Asset Management, a fund-management group based in the United Kingdom, has spent his entire career in asset management. Recently, he spoke with McKinsey's Martin Huber about the industry's future direction.

McKinsey on Investing: *You've spoken of a new era in asset management. What do you see as the fundamental differences between this era and the past?*

Edward Bonham Carter: It depends in part on which past you are talking about. In my career, there have been two major periods. The first was in the 1980s and 1990s, a period of falling inflation, falling interest rates, and rising profits. Industry in the West was deregulated. These were perfect tailwinds for equity markets. The second era began in the late 1990s, the period of irrational exuberance, as Alan Greenspan called it; the effect on equities was a long sideways move.

Today, people are trying to work off the debt accumulated during that second period. The big question for the new era is how we will deal with that debt. I see three possibilities: we grow our way out of it; we get inflation, which, as we know, is a transfer of value from the saver to the borrower; or there's some sort of default.

The challenges to growth are numerous. Big parts of the world are aging. I suspect there is overcapacity in the fund-management industry as a whole, though clearly there are pockets of excellence. The implication for the industry, especially at current valuations, is that it's probably prudent to assume relatively low returns from major asset classes in the medium term.

McKinsey on Investing: *Some aspects of the financial system have delevered; are we making adequate progress overall?*

Edward Bonham Carter: I don't think so. There has just been a reallocation of debt among the major players. Household debt has shrunk, but governments have added debt. Corporations are a mixed story. On the one hand, you hear stories of cash-rich corporations in Europe and the United States, but I think you have to be careful with that analysis. Some sectors are still quite leveraged, and some sectors are leveraging up to buy their shares back. And within the household sector, you have to do a cohort analysis among households because there are big differences. In June 2014, a new report found that the poorest 20 percent in the UK are just as badly off as the poorest in Eastern Europe; meanwhile, by many measures, the wealthy are better off than ever.

McKinsey on Investing: *You suggested that there is excess capacity in the asset-management industry, just as there is in other industries—is that right?*

Edward Bonham Carter: Yes, I think so. In some areas you are already seeing it, as in the Ignis Asset Management–Standard Life merger in UK insurance, for example. I suspect we'll see more of that, as both a reflection of the economics and the trend to separate the insurance and asset-management businesses. We might also see consolidation on the retail side; we're already seeing concentration of flows by sector. If we say that there are 90 funds in the UK equity-income sector, I suspect only 5 to 10 funds are getting significant net inflows. That's probably replicated across lots of other major product categories. Now, asset managers are quite profitable businesses, but if they're in outflow and the costs of doing business—regulations, technology, and compliance, for example—are going up, then that's going to squeeze the sector.

McKinsey on Investing: *That raises the question of scale. But scale in asset management has challenges and causes complexity. Big asset managers now often have manufacturing in many countries and sales in many others. How do you see the trade-offs of larger size changing?*

Edward Bonham Carter: I'll give you an example. We have agreed to sell our private-client business. It's a good business with "sticky" clients; if managed well, it can be an attractive business, both for the owner and for clients. The problem is getting it to scale. Today, it has £2 billion under management, which I would say is smaller than many competitors. We looked at the investment needed to grow it to, say, £4 billion, out of £30 billion we manage overall. We thought about both organic growth and inorganic, and decided the costs and the risks of a transaction were too high. In our view, it's better off being owned by someone else, letting us focus on a more streamlined business.

McKinsey on Investing: *Does digital change that and allow you to add assets faster than in the past?*

Edward Bonham Carter: Even firms with a brand name and a platform still have to work out the costs of acquiring and servicing new clients. They have to decide what kind of relationship they want. Do you want them coming straight through to your administration desk? If you subcontract that, what issues of brand and quality does that raise? The client will come to you in multiple and complex ways; companies need to analyze the servicing requirements carefully. Take advisory, for example. Companies need to reach the end customer and get the word out and help their distribution partners, the financial advisers. At the same time, they also sell through their own channel and need to be careful not to compete. It's one of the paradoxes of this industry: unlike

Edward Bonham Carter

Vital statistics

Born May 24, 1960, in London, England

Married, with 3 children

Education

Holds a degree in politics and economics from Manchester University

Career highlights

Jupiter Asset Management (1994–present)

Vice chairman (as of 2014)

CEO (2010–14)

Chief investment officer (1999–2010)

Manager, Jupiter Undervalued Assets Fund (2001–09)

Manager, Jupiter UK Growth Fund (1994–2001)

Electra Investment Trust (1986–94)

Schroders (1982–86)

Fast facts

Nonexecutive board director of Land Securities Group

Member of the investment committees of the Esmée Fairbairn Foundation and the Harrow School Foundation

Led successful management buyout at Jupiter in 2007 and IPO in 2010

Named *Financial News*'s CEO of the year, 2010

Received *Investment Week*'s Outstanding Industry Contribution Award, 2014

Commutes to work on a bicycle

other businesses, buying the product direct from the manufacturer is actually more expensive. To return to the question of the new era, I think that is changing. There is a whole new air of transparency into pricing, and I think we'll see some significant changes.

McKinsey on Investing: *You're an active asset manager. Is it harder today than in the past to convince your customer and your distribution channels of the value that you bring?*

Edward Bonham Carter: Yes, because people are colored by experience and are much more cynical now about the claims of the industry. That's partly because returns, in general, have not been that exciting, and they've been more volatile. We've had two bear markets since 2000, and people are scarred by that experience. They conflate the fact that market returns haven't been that good with the fact that a lot of active fund managers haven't delivered. Clients also say they want consistent outperformance, which is just not possible. All you can do over time is make sure that your good years more than offset your bad years and that you have active bets against the index—and that in so doing you justify your fees.

McKinsey on Investing: *In the United States, some investors now are suing what they call "closet indexers." What's your view on that?*

Edward Bonham Carter: Funnily enough, I think it's an opportunity. It makes our value clearer to investors who think all asset managers are the same. This story will make some people wary, but others will still want to have a part of their fund invested in an active way, with fund managers they believe in. It will add to the pressure on the industry for greater transparency on their investments and their fees. What it brings to mind is the contrast with hedge funds. Here, I think the long-only industry could learn something from hedge funds about pricing capacity. In the short term, asset managers are very sensitive to earning revenues; there's a tendency for people to keep their strategies open. But in the longer term, in certain strategies, mangers could be sharper at analyzing the capacity of the strategy, pricing the remaining capacity accordingly, and then closing it. In the 1990s, no one did that; recently, we've started to see it.

To relieve the pricing pressure, managers need to think about what's in the best interest of the client in the longer term. I suspect that in the institutional market, pricing for good institutional strategy has found a level and probably hasn't moved much in the past decade. In retail, the issue today is the split between the distributor and the manufacturer. My inclination is that the balance is going to tilt toward distributors.

McKinsey on Investing: *Do you think that the system is also going to change how people invest?*

Edward Bonham Carter: That's a hard one. In a sense, the answer is path dependent; if we had a deflationary scenario, you'd see an accelerated move out of equities, for example. But within that, I think some trends are here to stay: the move to products that are more solution based, the desire by clients for managers to allocate assets for them, the shift to absolute-return products.

McKinsey on Investing: *Who benefits from those trends—asset managers or the distribution channels?*

Edward Bonham Carter: Both can benefit, depending on their skill sets. If asset managers have good skills in-house for generating alpha in their space, they will get some of it, and some will absolutely go to wealth managers.

McKinsey on Investing: *Let me shift gears a little bit. We have heard a lot about wealth shifting into emerging markets; growth is dramatically faster than in developed markets. What impact do you think asset managers in these countries will have on the global market?*

Edward Bonham Carter: At the moment, there are still not that many home-sourced asset managers in emerging markets. So the technology, for want of a better word, is coming from the developed world, as people sell services and products into the emerging markets. On a ten-year view, as the emerging markets grow and add wealth, you would expect them to buy some of this expertise and technology. It might be like the way that Japanese companies bought some asset managers back in the 1980s and 1990s, though of course they then fell victim to their own economic cycle. We've seen Chinese firms try to buy various asset managers in the past few years. The questions are how fast will it happen, and will regulators encourage it or get in the way. You would also expect these countries would want to have their own indigenous asset managers. Maybe it's too early in their economic development, but there's no reason it won't happen.

McKinsey on Investing: *One more question on digital technology. Is it an opportunity? Is it a threat?*

Edward Bonham Carter: A part of me believes that human beings still like to deal with other human beings. I think some of the commentary today overemphasizes the pace of digital change, and one shouldn't forget that people want to meet and learn from other people face to face because of all the psychological benefits of that. I'm sure there are going to be huge changes in how managers access customers, how they use data to analyze markets, and how customers look through expert systems to help with decisions they need to make. Digital will hopefully improve the level of knowledge on both sides.

The danger is that we become drowned in an excessive load of information. That's not what we want in life; we want significant insights and analysis, things that add value to our knowledge and behaviors, not just more and more information. That's the challenge with digitization. It will be interesting to see how the next generations of investors respond to this. Are people going to stay cynical about advice, or will some say, "I pay my doctor and my accountant in this way; my financial adviser is a professional, and if he's good, I will pay him the same way"?

McKinsey on Investing: *Some say that another danger of digitization is that, if used to analyze a firm's decision-making algorithms, especially in the long-only business, it will simply replicate the firm's position. What could be counterstrategies to get around that?*

Edward Bonham Carter: The world of fund management is just beginning to understand some of these threats and the linked issues of flash trading and algorithmic trading. The questions of how shares are traded and monitored, and the kind of information that is made available, are critical because people need to know if certain types of investors are being favored or not. Is the quest for superior speed a healthy kind of arms race? We need to see more evidence that the market is working to the benefit of all participants.

Martin Huber (Martin_Huber@McKinsey.com) is a director in McKinsey's Cologne office.

Thriving in a world of low and flat: An interview with Douglas Hodge

The head of the world's largest fixed-income manager discusses the industry's past, present, and future.

Martin Huber

Douglas Hodge is PIMCO's CEO and a managing director of the firm. He has more than 30 years of investment experience. In June 2014, McKinsey's Martin Huber spoke with Mr. Hodge about the industry and where it is headed.

McKinsey on Investing: *You've referred to today's environment as a "world of low and flat." What does this mean for asset managers?*

Douglas Hodge: By low and flat, I mean a world in which the Fed funds rate is just over 0 percent, real rates are at –2 percent, and the yield curve is not steep. By comparison, we think the "new neutral" rate, in which GDP, employment, and inflation are stable, is about 2 percent nominal and 0 percent real. Rates below neutral, like we have today, produce an economy that finds it hard to grow out of its debt overhang, that is not favored by aging demographics, and that is vulnerable to geopolitical instability. Low and flat compresses risk premiums in fixed income and other financial assets, which makes prospective returns more difficult. For asset managers, that means you've got to be able to exploit opportunities either across a broader universe than you have traditionally operated in or in a deeper and more selective way.

Importantly, and paradoxically, it also means you've got to be prepared for volatility. Volatility right now is priced quite low. The new neutral we see suggests that volatility is going to stay low. But we also know, courtesy of Hyman Minsky, that low volatility can be a stage just before the top blows off. You've got to be ready, especially in the heavily traded fixed-income instruments.

McKinsey on Investing: *Can you say more about where asset managers need to look for opportunities?*

Douglas Hodge: This might mean markets that either are in emerging economies or in different parts of the capital structure. We might even need to go outside and push the limits even further into things that aren't securitized, where banks have historically operated, and get into primary debt origination. In this new neutral, if you're simply trying to jockey back and forth between heavily traded fixed-income instruments, risk premiums are so tight that it's going to be hard to earn consistent excess return.

I would say the same goes for stocks. If you look at the valuations of equities, say, in the US market, we're at levels now that do not offer much upside, unless you postulate higher growth. Growth would solve the riddle, but in our view growth is going to be modest. That's the real challenge, and there are just so many impediments. We see pockets of growth in the energy sector and even the housing sector. But income growth is hardly moving, labor participation is low, and then there is this whole demographic wave. Having lived in Japan for seven years, I have experienced the problem in which, as economies age, they hit a soft wall as they try to create above-trend growth.

McKinsey on Investing: *Is that "soft wall" what's happening in Europe, in your view?*

Douglas Hodge: I think so. Of course, the European Central Bank is doing everything in its power to avoid it, but Europe's political leaders are more afraid of unemployment than they are of the long-term consequences of slow or no growth. That said, I do think that the Brussels mind-set, if I can call it that, is beginning to soften a bit. Coming out of the crisis, the mission was to rewrite prudential regulation and rethink how markets work. Now political leaders are beginning to realize there's another dynamic to consider: growth. In my view, good regulation without growth leads to collapse, and growth without good regulation leads to crisis. Neither is acceptable. We need to strike a balance, and I

Douglas Hodge

Vital statistics

Born in 1957, in New York, NY

Married, with 7 children

Education

MBA, Harvard Business School, 1984

BA, Dartmouth College, 1979

Career highlights

PIMCO (1989–present)

CEO (January 2014–present)

Chief operating officer (2009–14)

Head of Asia office (2002–09)

Product manager and senior account manager (1989–2002)

Salomon Brothers (1984–89)

Vice president, fixed-income trader

Fast facts

Global executive-committee member, Allianz Asset Management

Executive-committee and board member, Securities Industry and Financial Markets Association think the regulatory community is beginning to soften just a bit on this.

McKinsey on Investing: *What about emerging markets? What do you make of the dynamics of growth there?*

Douglas Hodge: What's interesting to me about emerging markets is that while growth is lower but still strong, it is largely inaccessible to foreign institutions. Take three markets: Brazil, China, and India. These are very big, populous countries whose growth trajectories have been very strong—Brazil and China in particular—but the regulatory environment simply has not been friendly to financial institutions seeking to enter these markets. All three of them still have some version of capital controls. Not only does that make it difficult for asset managers to enter the market, but it also limits the ability of residents to invest in markets outside their home country. About ten years ago, China opened up its market a bit by allowing foreign asset managers to participate in joint ventures with Chinese firms. Now one after another of the Western banks and asset managers is pulling out. It seems odd to some people who say, "Aren't we right at the threshold of a new opportunity in China?" Clearly some people who have been there a long time are taking a different view.

McKinsey on Investing: *Some people are also expecting to see big emerging-market banks become global powers in asset management. Do you see potential there?*

Douglas Hodge: That's certainly a possibility. Given the valuation of some large financial institutions, they certainly have the currency to acquire. They haven't as yet, and perhaps they are mindful of the history here. The Chinese joint-venture experience is the most recent, but if you look back further, many of the acquisitions Japanese institutions made in the 1980s and 1990s ended in tears. There's example after example of failure rather than success, which I think tempers everybody's expectations from both sides of this equation.

McKinsey on Investing: *What do the competitive dynamics we've been discussing mean for customers' product preferences? Do you see significant opportunities in the retrenchment of banks and insurance companies from some of the businesses in which they traditionally have been active?*

Douglas Hodge: Banks and insurance companies have a different operating model from investment organizations. They use their balance sheet to underwrite liabilities: banks make loans, insurers make a promise, and they place them on their balance sheet. They then hypothecate their balance sheets, and that's how they make money. An asset-management firm essentially does not have a balance sheet but acts as an intermediary or agent. Our clients give us a portion of their balance sheets to invest in the capital markets. That's a fundamental difference in operating models; what we've seen so far is only limited demand for a combination of the two. Yes, we've had variable annuities and things of that nature, but they didn't perform well in the crisis; on the balance-sheet side, they weren't priced properly.

Will demand for a marriage of the two increase? It might. We've seen the demand for investment products become far more differentiated. The equity market has always had a differentiated product set—small capital, large capital, international growth, and emerging. But fixed income has been, for all intents and purposes, largely generic. One thing that PIMCO did was to differentiate bonds. Twenty-five years ago, one bond looked much the same as any other bond. We coined the term “total return”; now everybody has a total-return fund. As the industry shifts to include individual investors, products are becoming further differentiated. There are income-oriented products, long-duration products, and lots of variations on equity and emerging markets. Over the past year, we’ve introduced more than 100 new products. Some are regional variations, but most have a unique element.

That’s partially driven by the low-and-flat world; why would I lend you money for a longer period of time when I can get the same rate of interest for a shorter period of time? There has to be something different from simply the duration of the loan, the duration of the investment strategy, and that has created myriad responses from bond managers everywhere.

McKinsey on Investing: *So some of these products are things that a bank or insurer could underwrite against the balance sheet of clients or investors. But wouldn’t this introduce a whole new set of risks, creating an imbalance that might be conducive to another bubble?*

Douglas Hodge: Probably. One area where this kind of imbalance has gotten a lot of attention is the money-market industry in the United States, where there is an implicit promise to reset the net asset value to $1 per share every day, without any real backstop. Asset managers are operating in capital markets, but with a balance-sheet expectation from investors. Regulators are considering ideas such as floating net asset values to address the problem,[1] but they too look through the lens of the balance sheet and apply the balance-sheet mind-set to the asset-management industry. It just doesn’t map very well.

McKinsey on Investing: *Another topic that is at the center of industry debate now is digital. What’s your view on how digital is affecting asset managers in the short term, and will that change over the long run?*

Douglas Hodge: This is one of the biggest question marks for our industry. The people we serve are mostly in their 50s, 60s, and 70s. The next generation of wealth accumulators is going to be far more digitally aware than the current generation. No one has really figured out how to respond to that. Everyone understands now that, regardless of age, people are far more comfortable taking information through a digital portal. But when it comes time to transact, they want to do it with an individual. They want somebody at the end of the line. Asset managers can make information readily available through digital portals—websites, Facebook, other social media. And to a degree, that push can also pull people into your product set.

McKinsey on Investing: *Do you see asset managers working harder to communicate their value to customers, or are they more or less happy with the status quo?*

Douglas Hodge: No, there is constant pressure on fees in our industry. I don’t know if it is any more intense now than it has been in the past, but I do think it is going to continue to be intense. But the best asset managers can justify their fees. I continue to believe that there is a degree of inefficiency in capital markets. True, inefficiencies are harder to find, and how you think about investing in these opportunities has to change, because the dynamics of the capital markets are changing. Nevertheless, some of those things are going to create more inefficiency. And that's what active management is all about.

McKinsey on Investing: *One of those dynamics is that the balance sheets of the banks are getting smaller. Does that make your market more or less efficient?*

Douglas Hodge: It creates inefficiency. If you look across derivatives at the trading volumes of the banks, they've come down, while total volumes have actually gone up. What that tells me is that markets and market makers, including asset managers, are clever and creative and will continue to find opportunities.

McKinsey on Investing: *If I understand you correctly, you wouldn't be too unhappy about seeing more passive investing in the market because this provides you with more opportunities to trade on.*

Douglas Hodge: Passive is a mixed bag. It contributes to the compression of returns in a world of low and flat, but I also believe it creates more volatility. That volatility is an expression of inefficiency, and there are ways to take advantage of that. If everybody is buying the index, then the assets that are not in the index will be cheaper. Part of this is being driven by regulators, so it's not just the marketplace that's deciding. Some people are always going to choose the index; they think it's a more efficient way to invest their capital, and they're going to get a better risk-adjusted return.

[1] This interview was conducted in June 2014. In July, the Securities and Exchange Commission approved a floating net asset value for US funds sold to retail investors.

Martin Huber (Martin_Huber@McKinsey.com) is a director in McKinsey's Cologne office.

Alternative asset management

Jon Krause

23
Changing perceptions and new realities in private equity
Sacha Ghai, Conor Kehoe, Bryce Klempner, and Gary Pinkus

30
A conversation with Jim Coulter
Aly Jeddy and Gary Pinkus

36
Money isn't everything (but we need $57 trillion for infrastructure)
Robert Palter and Herbert Pohl

40
Private equity in India: Once overestimated, now underserved
Vivek Pandit

Changing perceptions and new realities in private equity

Industry performance is better than previously thought, but success is getting harder to repeat. Investors and firms will need to adapt to changing conditions.

Sacha Ghai, Conor Kehoe, Bryce Klempner, and Gary Pinkus

Private-equity performance has been misunderstood in some essential ways. It now seems that the private-equity industry decisively outperforms public equities with respect to risk-adjusted returns, which may prompt return-starved institutional investors to allocate even more capital to the asset class. But this good news comes with an asterisk: top private-equity firms now seem less able to produce consistently successful funds. That's because success has become more democratic as the general level of investing skill has increased.

The new priority for success is differentiated capabilities. Limited partners (those who invest in the funds raised and managed by general partners) expect funds that exploit a general partner's distinctive strengths will do well, while more generalist approaches may be falling from favor. Institutional investors will need to get better at identifying and assessing these skills, and private-equity firms will need to look inward to better understand and capitalize on the factors that truly drive their performance.

A new understanding of an elusive industry

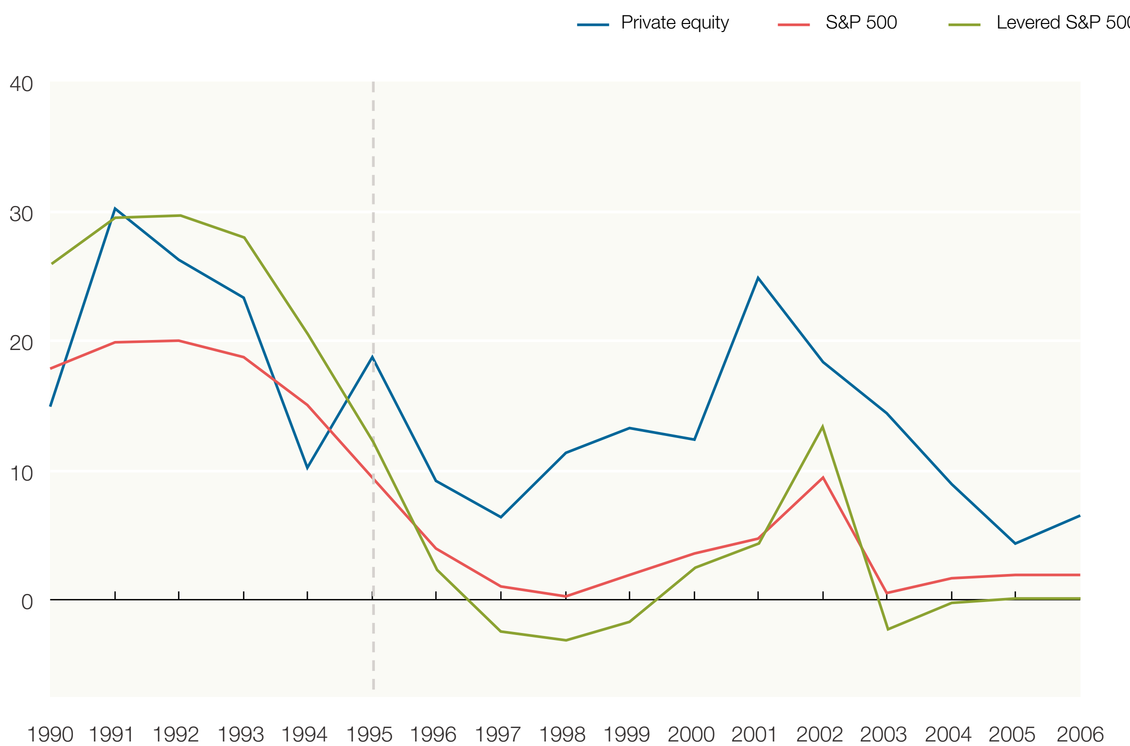
Private equity has grown from the equivalent of 1.5 percent of global stock-market capitalization in 2000 to about 3.9 percent in 2012. Along the way it has boomed and busted alongside public markets, while inexorably taking additional share. At the same time, many have observed that private equity—though ostensibly an "alternative" asset class—has in two ways drifted toward the mainstream. Several researchers concluded in the mid-2000s that, on average, buyout funds underperformed the S&P 500 on a risk-adjusted basis; only about a quarter of firms consistently beat the index. Other research has found that private-equity returns have become highly correlated with public markets.

As the perception of private equity's differentiation has waned, the fees that the industry charges investors, already under pressure, have come to seem excessive to some. And as firms have come under fire for some of their practices, they have

Exhibit 1

Private-equity returns have historically outperformed.

Investment returns for private equity and S&P 500 (levered and unlevered),[1]
internal rate of return, %



[1] Analysis based on a cash-flow-matching approach; assumes that investment into and out of public equities matched the average of cash called and returned by private-equity companies, after initial fund-raising in vintages 1999–2009, except for vintages 2004–06, where 5.5-year returns of S&P were used.

Source: Bloomberg; Cambridge Associates; Preqin; McKinsey analysis

not always done a good job of explaining their role to the public.

These are serious challenges but, if returns are only average, none of the rest matters very much. Private-equity returns are, however, notoriously difficult to calculate. By and large, the industry does not publish its results; the data that are available can be inconsistent and hard to reconcile, as both private-equity firms and their limited partners use diverse approaches for their calculations. Making things more difficult, a database on which researchers have relied turns out to have had serious methodological issues.

Encouragingly, new research based on more recent and more stable data suggests that private-equity returns have been much better than previously supposed, though top firms' performance is now somewhat less consistent. The conventional wisdom on returns stems from analyses of funds raised in 1995 and earlier. In January 2011, McKinsey developed an analysis for the World Economic Forum in which we found that funds created since 1995 appear to have meaningfully outperformed the S&P 500 index, even on a leverage-adjusted basis (Exhibit 1). Two academic teams have since reached similar conclusions.[1] Both find that over the long term, private-equity returns have outstripped the public-market index by at least 300 basis points.

Other McKinsey analysis finds that the persistence of returns—in particular the tendency of top firms to replicate their performance across funds—is not nearly as strong as it once was. Until 2000 or so, private-equity firms that had delivered top-quartile returns in one fund were highly likely to do so again in subsequent funds. Knowing that yesterday's winners were likely to excel again today enabled limited partners to focus their due diligence on identifying top-quartile funds.

Since the 2000 fund vintage, however, this persistence has fallen considerably (Exhibit 2). At the same time, the focus of value creation in the industry has shifted from financial engineering toward improvements in the operating performance of portfolio companies. These shifts are forcing limited partners to develop new means of predicting tomorrow's winners. Meanwhile, returns remain widely dispersed: the best funds in any vintage generate returns of about 50 percent, while bottom funds lose up to 30 percent of their investment. With persistence waning and dispersion still significant, selection risk remains as high as it was in the 1990s, but it has become tougher to predict which firms will deliver top-performing funds.

Poised for growth, with new complications

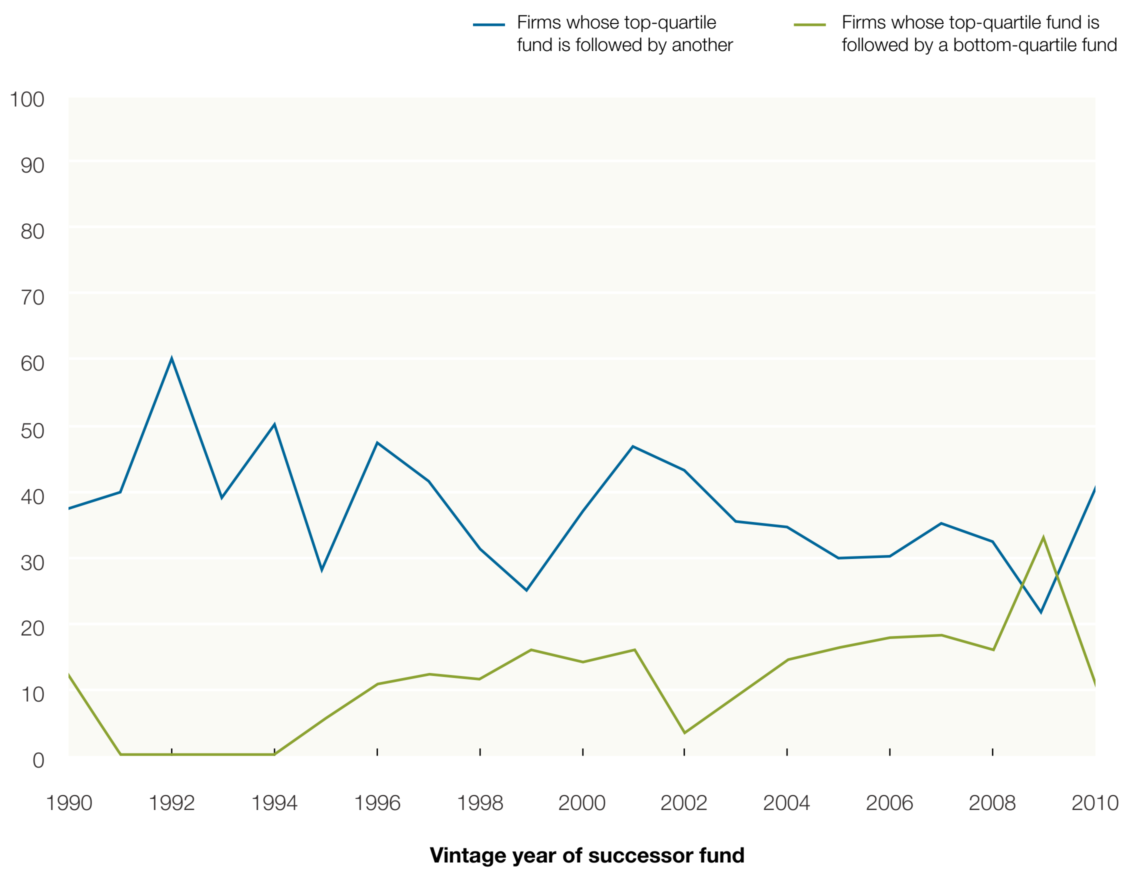
These insights on persistence and dispersion are important nuances to the larger story: private equity is a more attractive investment class than was previously understood. A 300-basis-point gap in returns makes a world of difference: a 9 percent annual return from private equities is a big improvement on the 6 percent or so that institutional investors tend to expect from listed equities. Confirmation of this persistent performance superiority means that return-seeking limited partners, especially those like pension funds that also crave stability, will likely increase allocations to private equities. The industry can also look forward to a new wave of commitments from high-net-worth individuals as private-equity firms roll out new retail offerings and distribution mechanisms.

As a result, we believe the industry is on the verge of a new phase of growth in capital under management—though with the history of troubled data, the potential for other possibilities must be acknowledged. But where will this additional capital be deployed? There are several possibilities. One is that fund size will rise as general partners seek larger deals. A recent McKinsey analysis found no meaningful correlation between performance and either deal size or fund size. If the boom era's megadeals prove successful and borrowing costs remain low, then more such large transactions are likely as the demand among institutional investors to deploy large amounts of capital continues to increase. Another possibility is that private-equity firms will look to more nascent markets and to adjacent asset classes. Finally, firms could expand the universe of potential targets simply by lowering their return expectations.

Exhibit 2

Top firms no longer outperform as consistently.

Firms that produce consistent/inconsistent performance from fund to fund,[1]
%



[1] For some early vintages, a small sample size may increase volatility in fund performance.

Source: Preqin; McKinsey analysis

But before the industry can accelerate to its full potential, some questions must be answered. Limited partners are increasingly concerned about management fees; some also wonder if they can get the scale they need, or if private equity will remain a small slice of their portfolio. While fund-raising in 2013 was the highest in five years, many general partners are struggling to raise new funds on the heels of disappointing recession-era vintages, let alone to convince limited partners to commit larger sums. Both sides will need to take stock and design strategies to capitalize on the new realities in private equity.

An agenda for limited partners

The shifts in the industry are pushing limited partners to rethink their general partner–selection capabilities. Despite the drop-off in persistence, the reward for selecting the best general partners is still great—but making that choice is now much more difficult. Track record is no longer a reliable indicator. General-partner selection is becoming more focused on understanding the capabilities that have driven past returns and assessing whether those capabilities are still present, relevant, and sufficiently differentiated to continue to drive outperformance into the future.

To make these assessments, limited partners will need to generate deeper insights into the drivers of private-equity performance, follow these insights to identify high-potential geographies and sectors, and have the conviction to use these insights to select external managers. The challenge of acting on conviction is particularly acute in the emerging markets, where shorter track records and even spottier data create further challenges in general-partner selection.

Achieving such insight will require real investment in research and in due diligence of managers. These capabilities should be built by enhancing the talent base within institutional investors and exploiting data through advanced analytics. In addition, investors will need to improve the general knowledge and understanding of private equity among their board members, as these directors are often entrusted with asset allocation and manager selection.

Some limited partners have begun to "insource," effectively doing private-equity investments on their own. Recent academic research has found this approach preferable for institutional investors in certain circumstances; direct private investment saves fees and can generate better results than an external manager. The research considered a small sample of seven Canadian pension funds that have enjoyed higher returns from their own deals than from their investments in private-equity funds or even from their coinvestments in the funds' deals.

While the returns may be enticing, this kind of forward integration is not for everyone. Many institutions may face daunting structural obstacles, notably in their ability to hire, govern, and retain top talent. And the effort put forth by the Canadian investors was substantial: first, they had to establish professionalism in their management and governance, including the board. To build and sustain internal teams of investment professionals with the right skills, the funds had to be able and willing to provide an attractive level of compensation that was frequently much higher than that of professionals in other asset classes. The funds had to learn to trust these professionals with investment decisions. And they needed to build strong research teams to understand the cyclical and structural trends of private markets to determine the optimal time to invest.

How general partners might respond

General partners have several options they might consider. To raise capital in a newly competitive era, private-equity firms must be able not only to point to a track record of success, as in the past, but also to say how that track record was achieved and, even more critically, how it will be maintained. As such, private-equity firms may need to develop a more detailed understanding of their past performance and be able to describe its fundamental underpinnings—in particular, the skills, brand, focus, and other capabilities that the firm brings to its deals. They may also need to explain how these capabilities are evolving to allow them to keep ahead in a competitive market. Limited partners are looking for clear, differentiated strategies, with relevant and proven capabilities; general partners will need ready answers.

As a simple example of the kind of distinctive skill and insight that limited partners may now seek, McKinsey research has shown that deal partners with strong transaction backgrounds add considerable value to transactions in roll-ups (deals made to expand market share in a given industry)—but not as much when companies develop organically. The converse is true for those with managerial or consulting backgrounds.[2]

Knowing how a differentiated value proposition and strategy for the future generates performance can help a general partner articulate one that sets it apart from both its private-equity competitors and from limited partners that aspire to invest directly. It may want to review the possibilities for increasing its specialization, by sector, geography, or deal type. It should consider cataloguing its skills, identifying both the relevant abilities it has and those it needs to deepen or build from scratch. It can then raise funds for investments that can only succeed with those skills. Imagine a firm with exceptional skills in chemical deal making and operations. It might raise a fund with a 15-year lifetime, rather than the usual 10 years, to ensure that it was active through at least two of the industry's cycles. And it might swear off any investment that is not directly tied to the subsectors in which it specializes.

As limited partners concentrate their investment with fewer firms, general partners should consider ways to integrate investors further into their business system. General partners already regularly invite their limited partners to coinvest in some deals, where a decade ago they might have formed a consortium with other buyout funds. But more is possible. For example, general partners may provide investment advice to limited partners on some portions of their portfolio that are not invested in private equity. A general partner with expertise in China, for example, may counsel a limited partner on how to invest there. And general partners might look to limited partners as an exit route for certain types of businesses that limited partners may want to own for the long term. All these closer relationships can benefit both parties.

As limited partners concentrate their investment with fewer firms, general partners should consider ways to integrate investors further into their business system.

General partners can also consider some bold changes to their incentive structures. In an era of smaller fund sizes, the 2 percent management fee was designed to "keep the lights on"—that is, to cover basic operating costs. It was a way to simplify the annual process in which the investment firm submitted its budget to investors for approval. Today, even though most firms have lowered the fee, it is often a major source of income. Some institutional investors worry that it distracts managers from their main task of generating returns. Firms have an opportunity to distinguish themselves by shifting incentives away from the management fee and toward carried interest. This is not a zero-sum move; rather, it should increase the size of the profit pool that general partners and their investors share.

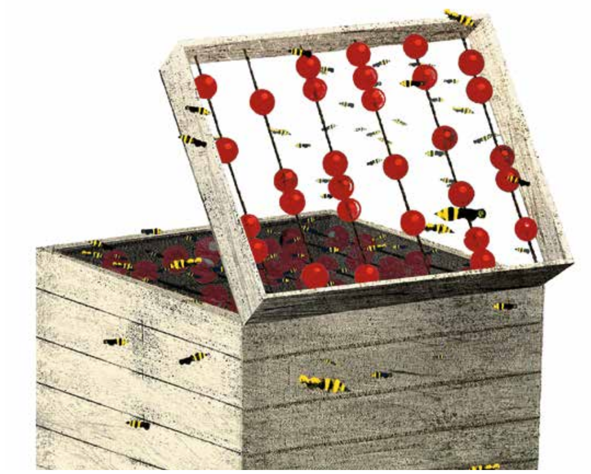
Along these same lines, firms can also offer options to their investors. Some leading firms, for example, now allow investors in some funds to choose either "1 and 20" (a 1 percent management fee and 20 percent of carried interest) or "2 and 15." Firms may also consider changes in the calculation of carry. Measuring carry by its true rate of return rather than returns in excess of an absolute threshold (typically 8 percent), as is the common practice, can better align the interests of general partners and their investors.

It remains to be seen if the next phase of private-equity growth can match the last boom. What does seem clear, though, is that limited partners will have to work harder and smarter to find top funds, and general partners will need to become better marketers of their unique abilities.

[1] Robert S. Harris, Tim Jenkinson, and Steven N. Kaplan, "Private equity performance: What do we know?," National Bureau of Economic Research working paper, Number 17874, February 2012, nber.org; Chris Higson and Rüdiger Stucke, "The performance of private equity," Coller Institute of Private Equity, London Business School, February 2012.
[2] Viral V. Acharya and Conor Kehoe, "Board directors and experience: A lesson from private equity," *McKinsey on Finance*, Number 35, Spring 2010, mckinsey.com.

The authors wish to thank Aly Jeddy for his contributions to this article.

Sacha Ghai (Sacha_Ghai@McKinsey.com) is a director in McKinsey's Toronto office, **Conor Kehoe** (Conor_Kehoe@McKinsey.com) is a director in the London office, **Bryce Klempner** (Bryce_Klempner@McKinsey.com) is a principal in the New York office, and **Gary Pinkus** (Gary_Pinkus@McKinsey.com) is a director in the San Francisco office.



A conversation with Jim Coulter

The veteran investor discusses alternative assets, shifting currents within the industry, and how management fees are like a two-by-four.

Aly Jeddy and Gary Pinkus

Jim Coulter is cofounder and CEO of TPG, a leading global private-investment firm. As one of the principals in the creation of the modern private-equity industry and an experienced investor in alternatives, Coulter has seen most of the sector's ups and downs. McKinsey's Aly Jeddy and Gary Pinkus spoke with him in September 2014. The following is the first part of the conversation; the second part will be published in the next edition of *McKinsey on Investing*.

McKinsey on Investing: *Looking ahead at the next five to ten years, how do you think the alternative-asset-management industry will evolve? What wild cards might be out there?*

Jim Coulter: I think people may continue to be surprised by both the industry's rate of growth and its increasing complexity. In 1992, when TPG started, a forecaster would have massively underestimated the growth and the increase in scope of the industry. We risk making the same mistake today. We now have pretty compelling data that, whether on returns or Sharpe ratio, the asset class on balance has performed at levels that make it likely to continue to attract capital. An important consideration here is the ongoing general debate about passive versus active management. Active management has become the flavor of choice for certain investors—perhaps the only practical flavor for them—and they've been paid handsomely for participating, including risk and liquidity premiums. Our investors are voting with their dollars: they're holding or increasing their commitment to alternatives.

McKinsey on Investing: *Are you also seeing new investors enter the business?*

Jim Coulter: We've seen new entrants of almost all sorts. At one end, private equity and alternatives have become an acceptable asset class for the largest owners of capital in the world, sovereign-wealth funds, and other government-related funds. Outside of Singapore, this was probably not true 10 to 15 years ago. At the other end, alternatives have certainly captured the attention of high-net-worth and even retail investors. While to date these groups make up only a small part of the market, if those paths open up and returns continue at today's level, they may be a substantial contributor to industry growth.

McKinsey on Investing: *Private equity—and buyouts in particular—is a big part of alternatives. Is there a natural limit to the growth of buyouts? Will the secular-growth trend run out at some point?*

Jim Coulter: Today it's unclear, at least in the United States and Europe, whether the secular-growth trend in buyouts may be flagging. Let me make both sides of the argument. First of all, growth in private-equity assets under management has begun to flatten. That's visible in the distribution-to-capital-call ratio, which has moved to close to two. The industry is returning substantially more capital than it is calling. Further, the volume of new transactions in private equity as a percent of assets under management has decreased. If you disregard secondary buyout transactions and look at new purchases of assets not previously held by private equity, they are at a historic low. So that would argue that the meteoric growth of the past 20 years has potentially begun to level off.

On the other hand, the real-estate market, where substantially more assets are held in private hands than public hands, might be a model for private equity. Among companies, there has been a long-term secular movement toward public ownership. As private equity has grown, many have wondered whether private ownership might not be a better model. So there's a possibility that we will see an increased mix of private versus public ownership of large corporations.

The other thing that argues against the plateau is that any time in the history of this business we probably could have argued that growth would level off. Instead, growth in assets under management has continued in a way that has surprised even those of us close to the market.

McKinsey on Investing: *Your firm and many of your peers have increasingly adopted a multiasset strategy. What are the arguments for and against that approach?*

Jim Coulter: The shift to multiasset is often portrayed as general partners (GPs) leading their investors. We tend to view it as limited partners (LPs) leading the market and GPs serving their clients. Alternatives began in equities; you can think of private equity as bringing alternative asset tools to the equity marketplace. Over the past few years, the application of alternative asset tools to the credit markets has probably been the fastest-growing segment of the industry. Additionally, we've seen growth in hedge funds, which are active managers in a variety of different public markets. We're on a long-term trend: the wave of active, alternative management that started in private equity is now heading into hedge funds, debt, real estate, and other related asset classes, driven by LPs looking for differentiated returns.

In this evolving marketplace, LPs tend toward a "barbell" strategy of investment. On one side of the barbell, there are point products, such as small, midmarket buyout funds or Asian country funds. Many LPs seek these products, but they are difficult to scale, and as these areas are often new, LPs are faced with new managers. On the other end, there are firms that offer multiasset solutions, such that a state pension-fund client can invest in multiple products with the same manager. Both of these approaches are creating acceptable and interesting returns.

McKinsey on Investing: *You could argue that solutions firms are providing a single point of entry to multiple products with a common brand. But you could also imagine much more customized solutions across those products, designed to answer particular problems.*

Jim Coulter: Sure. I find this structural tension—point products versus solutions—occurs in lots of intellectual-property industries. A company could buy specialized consulting products from a number of small consulting firms, or it could purchase a bundle of them from a larger firm. For its investment-banking needs, a corporation could work with a small boutique, or it could work with one of the large banks on a broad-based set of solutions. Likewise, in the regular asset-management business, investors tend to cluster around the large platforms, such as BlackRock or Fidelity, that can offer multiple and tailored solutions to their needs. So the solutions-based industry structure we see developing in alternative assets should not be a surprise; the recent acceleration in this trend is, however, a surprise.

McKinsey on Investing: *That goes back to the original point you made, about the rate of growth and rising complexity.*

Jim Coulter

Vital statistics

Born December 1, 1959, in Buffalo, NY

Married, with 3 children

Education

Graduated from Dartmouth College and Stanford Graduate School of Business

Career highlights

TPG (1992–present)

Founding partner and CEO

Keystone Asset Management (1986–92)

Fast facts

Serves on numerous corporate and charitable boards

Serves on the Dartmouth College board of trustees and the Stanford University board of trustees

Cochairs the LEAD Commission, which seeks to develop a blueprint detailing the opportunity for using technology as a catalyst to transform and improve American education

Jim Coulter: And diversity. Many people still think of Blackstone as a private-equity fund, but if you look at its asset mix, it's only about 25 percent private equity. It's been a stunning change since 2005. The same is now true of other large firms. That expansion of products and rapid growth away from private equity is indicative of some of the trends within the industry but also of the buying trends of the LPs.

McKinsey on Investing: *You could imagine a world emerging like the one often speculated about years ago, in which hedge funds and private-equity firms seemed to have overlapping mandates, at least for a period of time. Do you think traditional asset managers with an alternative capability are starting to merge with alternative asset managers that may or may not have a traditional capability?*

Jim Coulter: It's going to be interesting to watch this play out. Your research tells us that in the next decade or so, perhaps 40 percent of the entire fee base of the asset management business will be in alternatives. Leading traditional managers will find it hard to ignore the need to either build or buy an alternative asset business. At the moment, we do not see traditional asset managers as competitors at the front lines of our business. We haven't been bidding against them for assets, other than in certain growth areas where they will invest directly as bridge capital in front of an IPO. But generally, they're not active as primary producers. Where they are active, and where they'll claim fairly large assets under management, is as solutions providers to their investors through funds of funds, bundling of hedge-fund products, and occasionally secondary participation in alternative assets. So it's not inconceivable to me that over time traditional managers will consider purchases of alternative asset platforms as a form of forward integration into investing areas they haven't been able to build internally.

McKinsey on Investing: *What about the flip side of the question: Is there anything interesting in traditional managers for alternative firms?*

Jim Coulter: Yes, it might make sense for one of the leading alternative asset platforms to buy a traditional asset manager. Some of the cultural aspects may be difficult, however. The argument for such a purchase would be based on improving customer relationships, distribution, and scale.

McKinsey on Investing: *All of this is based on the higher fees that alternatives currently command. Where do you see those fees going? If more capital comes in, will the price that you can charge for that capital continue to come down? Or do you see some break in that trend?*

Jim Coulter: When we talk to people about alternative fees, I always hear about 2 and 20. My response is to ask them, how large is a two-by-four? The answer is that it's about an inch and a half by three and a half. A two-by-four is not a two-by-four. Likewise, 2 and 20 doesn't exist in the large-scale private-equity market, other than for some small products. There has already been a substantial move in fee structures. It doesn't always show up in the headline pricing, but it shows up in discounts for size and for first closers, as well as in changes in transaction-fee splits between LPs and GPs and in coinvestment, the topic of the day. Fees per dollar invested have generally been decreasing for larger firms, and I expect that to continue.

Alternative asset managers have two choices. You can maintain your fund size, in which case you may be able to maintain pricing. Or you can grow your fund size, either from new investors or more capital from current investors. As you grow, you will see, as you do in most industries, a reduction in pricing. I don't think that's a bad thing. I think it's true in almost all financial products over time. As they grow and mature, pricing tends to come down.

McKinsey on Investing: *You talked about coinvestment. Some LPs are building true direct-investment programs, doing what I'll call parallel play to what you are doing. Do you see that as a blip or more of an enduring trend?*

Jim Coulter: Relationships between LPs—especially the larger investors—and GPs will get substantially more complex. Ten years ago, the market was clearly dominated by fund vehicles in an LP or GP setting, and essentially all LPs paid the same price, no matter their size or influence. When you think about it, it's an odd structure. There are very few industries where people who invest $10 billion pay the same fee as people who invest $10 million, but that was where alternatives were ten years ago. A number of the large LPs began to ask whether they shouldn't get better terms, given their size. Others began to see if they could go around GPs, which they viewed as expensive, to approach the market directly.

This trend has played out in a couple of ways. First, several larger LPs began coinvestment programs, which they viewed as a way of meeting excess demand and reducing the overall cost of their program. In some ways, coinvestment began to squeeze out GPs' traditional process of partnering with one another when they needed more capital. Coinvestment essentially pushed out consortiums, which the GPs welcomed.

Second, some of the larger LPs realized that they were investing enough to warrant an internal staff to make judicious decisions on direct investments. Generally, they chose to make those investments in partnership with their GPs. However, coinvestment structures allowed them to reduce costs while increasing the size of and influence they had over certain investments.

What we have not seen yet is extensive direct disintermediation; there have been few direct deals not done in partnership with one of the GPs. However, it may well happen in the future.

McKinsey on Investing: *And your view is that this just adds complexity to the market, rather than shifting the power dynamics?*

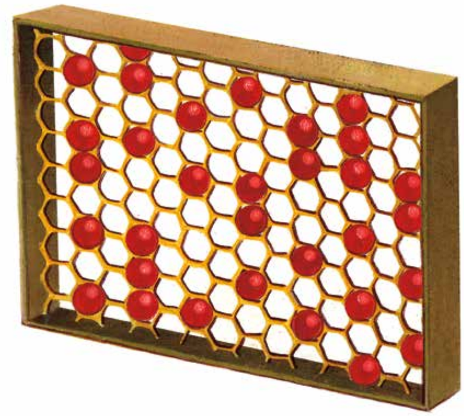
Jim Coulter: This market will inevitably become more complex, just as most financial markets do over time. Large investors will require some choice of structures and deserve a response. It's a little bit like the airline industry. The largest carriers can sit down with manufacturers to \design the next generation of aircraft. Small carriers just buy an airplane. Likewise, large investors will continue to help design the structure of the alternative asset industry, and GPs will be responsive to their desires.

Interestingly, one of the risks to larger investors will be if the retail markets open up, allowing individual investors to enter the alternative market. This could reduce some of the market power of the large institutions.

McKinsey on Investing: *Recently, the California Public Employees' Retirement System said it will get out of its investments in hedge funds. Obviously, this is interesting in and of itself—but is it a bellwether of a larger trend?*

Jim Coulter: In a bull-market period when multiples are expanding, generally speaking, passive management will look relatively more attractive than active management in the public markets. The past few years have been one of the stronger periods of multiple expansion, certainly in my career. One could argue that, during this period, investors in hedge funds have not seen adequate returns for the fees involved. It's not true of all hedge funds—many of them work well. But will the outperformance of passive management be true in the next part of the cycle? Only after the cycle turns should we comment on whether the decision to exit hedge funds is right or wrong. In the short term, though, we do think we will see pressure on hedge-fund fees.

Aly Jeddy (Aly_Jeddy@McKinsey.com) is a director in McKinsey's New York office, and **Gary Pinkus** (Gary_Pinkus@McKinsey.com) is a director in the San Francisco office.



Money isn’t everything (but we need $57 trillion for infrastructure)

A massive funding gap will open in coming years. New research shows how to close part of it.

Robert Palter and Herbert Pohl

“Where will the money come from?” would seem to be the question of the day in infrastructure circles. Governments from India to Ireland are under pressure to find new sources of funding, preferably at cheaper pricing and longer tenors. Basel III hems in infrastructure development on one side and Solvency II on another. Shrinking economies don’t have money; growing ones face a swelling bill for new infrastructure.

There is no shortage of projects being proposed, some with price tags running into several billion dollars. But when investors are presented with a project, they do not always find it investable. Even where private finance is available, not every project can be made attractive for all parties; it may require expensive wrangling and restructuring to do so. Capital is left parked at a time when it is needed more than ever.

Infrastructure investors and builders do not have far to look for suggestions for addressing the funding crunch, from public- and private-sector project-bond initiatives to government-guarantee schemes and infrastructure-debt funds. These are important and valuable solutions to a problem of liquidity, but in reality the industry faces a greater problem of growth.

Less an infrastructure gap, more a chasm

Drawing on an extensive database of historical infrastructure spending as well as a new approach to roughly size infrastructure needs, new research from McKinsey’s Infrastructure Practice and the McKinsey Global Institute estimates that $57 trillion will need to be spent on building and maintaining infrastructure worldwide between now and 2030—just to keep up with global GDP growth.[1]

If anything, this estimate is on the conservative side. It is restricted to a number of core infrastructure classes—transport, power, water, and telecommunications. It does not include the cost of addressing historic backlogs in repair and maintenance, nor of “future proofing” infrastructure against the increasingly volatile effects of climate change, and it does not account for any efforts to accelerate development spending in the least-developed countries.

Yet the scale is daunting: fully 60 percent more than the $36 trillion spent in the same 18-year time frame just ended and greater than the estimated value of all the world's infrastructure assets today. And this is a modest estimate.

Look at it that way, and the challenge of squeezing a few billion dollars more out of one country's pension funds or another's infrastructure bank—initiatives that do not always cross national borders—soon pales into insignificance. Even if institutional investors were to achieve their target allocation in infrastructure, it would mean additional funding of only around $2.5 trillion by 2030. Neither the public nor the private sector has acknowledged the scale of the infrastructure gap, much less admitted responsibility for it. Neither side can resolve this alone; both will suffer if nothing is done.

How to save $1 trillion a year

The solution the research proposes is as surprising as it is potentially game changing. It does not mean tearing up project finance, selling all public assets, or taking other radical approaches, because the evidence doesn't show that they are effective. Instead, it suggests procuring and managing infrastructure more productively.

By making small but important adjustments at every step of an infrastructure project, from the outline business case to routine operation and maintenance, we estimate that 40 percent cost savings can be made on infrastructure investments across the world, the equivalent of $1 trillion a year, every year, until 2030. This is not the result of a theoretical model but of identifying quantifiable benefits from proven best-practice methods in 400 case studies. These methods are the exception to the rule in an industry surprisingly resistant to performance enhancement. By implementing these practices globally and allowing for geographical variations, we believe that asset owners can attain the target.

The savings derive from three main levers: optimizing project identification and selection, streamlining project delivery, and getting more out of existing infrastructure. Our case studies, while focused on the actions carried out by governments, procurers, and contractors, open the door to investors to identify and call for best practices to be implemented from day one—particularly in asset-ownership models where the delivery of construction, renewal, and maintenance is often contracted out.

Streamlining project delivery can be taken up by investors from their earliest involvement. In most cases, in the absence of guidance from authorities or owners, project bidders and technical subcontractors have avoided designing and building for productivity. Design-to-cost principles, which can now prevent overspecification in project design, are just one example. In the operational phase, project owners can take advantage of operation and maintenance efficiencies such as a total-cost-of-ownership approach, allowing them to find the sweet spot between routine maintenance and major renewal.

In addition to saving money on existing assets, productivity means not spending money on new projects when it is possible to get more out of existing infrastructure for the same, or a better, outcome. Too often, notably in the transport sector, adding capacity simply stimulates demand, If the industry is to save $1 trillion a year, it must also stop investing in futile or badly structured projects . . . . By building less, the industry can build more of what it really needs.

leading to yet more congestion. Demand management is a cheaper option, and one of the best tools is user charging.

User charges reduce the need for costly new construction and allocate demand that would otherwise put a greater strain on infrastructure. For instance, peak charging for electricity in California has resulted in the lowest consumption in the United States, while road pricing has reduced congestion problems significantly in London and Stockholm. Imposing charges on the public is inevitably controversial. But shifting the burden of repayment from government to the end user breaks the demand-capacity feedback loop and captures the economic benefits that more productive infrastructure brings.

If the industry is to save $1 trillion a year, it must also stop investing in futile or badly structured projects. This will be a challenge, given the incentive for the public and private sectors alike to overemphasize the benefits of a project and favor eye-catching new builds over getting the most out of existing assets. The financial sector needs to engage early with government, even before an outline business case is on the table, to ensure that perverse incentives are resisted and financial structures—including a sufficient return to cover investment—are sound. Only then can capital be freed up for infrastructure renewal and construction that works and makes a difference by supporting GDP growth. By building less, the industry can build more of what it really needs.

Although some of these measures may sound like common sense, the scope for productivity gains in the infrastructure sector should not be underestimated. Indeed, while other industries have made dramatic advances in productivity over the past century, there have been no comparable gains in infrastructure investment. Many countries and project sponsors apply bits and pieces here and there, but few consistently apply all of the best-practice measures—all of which have been proved, tested, and had their impact measured in the past decade. Infrastructure productivity can be implemented in emerging as well as developed markets, irrespective of capital structures available.

Following these best practices can reap large benefits for the public sector. Better project selection as proposed above not only leads to better infrastructure but also lowers the risk premiums payable to private parties. Cheaper projects will better fit within funding envelopes and, in time, project-cost estimates should come down.

Contractors should welcome productivity savings as they increase their competitiveness and ability to budget for and win more contracts. Investors will see their rates of return increase and their capital go further. These substantial, tangible savings have profound implications for the financial modeling of new projects and accounting of existing assets. With a lower initial investment, the same revenues and coverage ratios can be achieved. Through tighter contract structures, risk profiles can be improved. Projects that were hitherto expensive or required unacceptable levels of subsidy may be transformed.

An interventionist, active approach to financing is essential. And while most investors may be less familiar with this method than private-equity players and those involved in project restructuring are, it is not necessary to exercise cure rights in order to practice active ownership.

If the infrastructure gap is to be closed through the championing of best practices, then it will require a new level of cooperation between public and private sectors: one that reflects the size of the challenge and how it puts whatever competing priorities they have in the shade. The imperative to deliver better infrastructure and meet the growing demands of the world population is a moral as well as an economic one; as global players, infrastructure investors are well placed to meet the challenge and do not need to wait for governments.

[1] For more, see *Infrastructure productivity: How to save $1 trillion a year*, McKinsey Global Institute, January 2013, on mckinsey.com.

Robert Palter (Robert_Palter@McKinsey.com) is a director in McKinsey's Toronto office, and **Herbert Pohl** is an alumnus of the Dubai office. This article appeared in *Infrastructure Journal and Project Finance Magazine*, ijonline.com, in March 2013, and is reprinted here by permission.

Private equity in India: Once overestimated, now underserved

General partners can use lessons from the past decade to build a new and better future.

Vivek Pandit

In the early years of this century, private-equity (PE) firms and their investors were enthusiastic about India's potential. Fifty percent of the country's 1.1 billion people were younger than 30. From 2003 to 2007, GDP grew by 7.5 percent annually, 88 million middle-class households were formed (more than twice the number in Brazil), urban dwellers grew by 35 million to 330 million, and 60 percent of the population was in the labor force. Banks' nonperforming-asset ratios fell from 9.5 percent to 2.6 percent. Further, the PE-to-GDP ratio stood at 1.8 percent, reassuring investors that India had plenty of headroom when compared with developed markets such as the United Kingdom (4.2 percent) and the United States (4.4 percent).

Private investors poured about $93 billion into India between 2001 and 2013 (Exhibit 1). At first, returns were strong: 25 percent gross returns at exit for investments made from 1998 to 2005, considerably better than the 18 percent average return of public equity. But returns fell sharply in following vintages; funds that invested between 2006 and 2009 yielded 7 percent returns at exit, below public markets' average returns of 12 percent. In fact, India's PE funds in recent years have come up well short of benchmarks: with a 9 percent risk-free rate and a 9.5 percent equity risk premium (accounting for currency risk, country risk, and volatility), the climb for Indian PE investors is undisputedly steep. To be sure, returns are based on a small number of exits, but that in itself is a problem. Only $16 billion of the $51 billion of principal capital deployed between 2000 and 2008 has been exited and returned to investors.

This article will explore the reasons why expectations may have been overly rosy, the headwinds that few investors escaped, and the behaviors that firms fell into. As the industry matures and resets its sights more realistically, a new wave of growth seems within reach. Five factors can tilt the balance: an increase in a bias in favor of control investments, appreciation of the complexity of family-owned businesses, new supplies of mezzanine financing, greater scrutiny from limited partners over general-partner strategies and capabilities, and encouragement from regulators.

Understanding what went wrong

Where did PE firms go wrong? Many in the industry suggest that the management approach favored by North American buyout firms was ill suited to the Indian opportunity and was made worse by the inexperience of PE firms operating on the home turf of experienced promoters (a unique form of business owner and investment syndicator). However, there are better explanations, in two categories, which provide lessons for investors to explore.

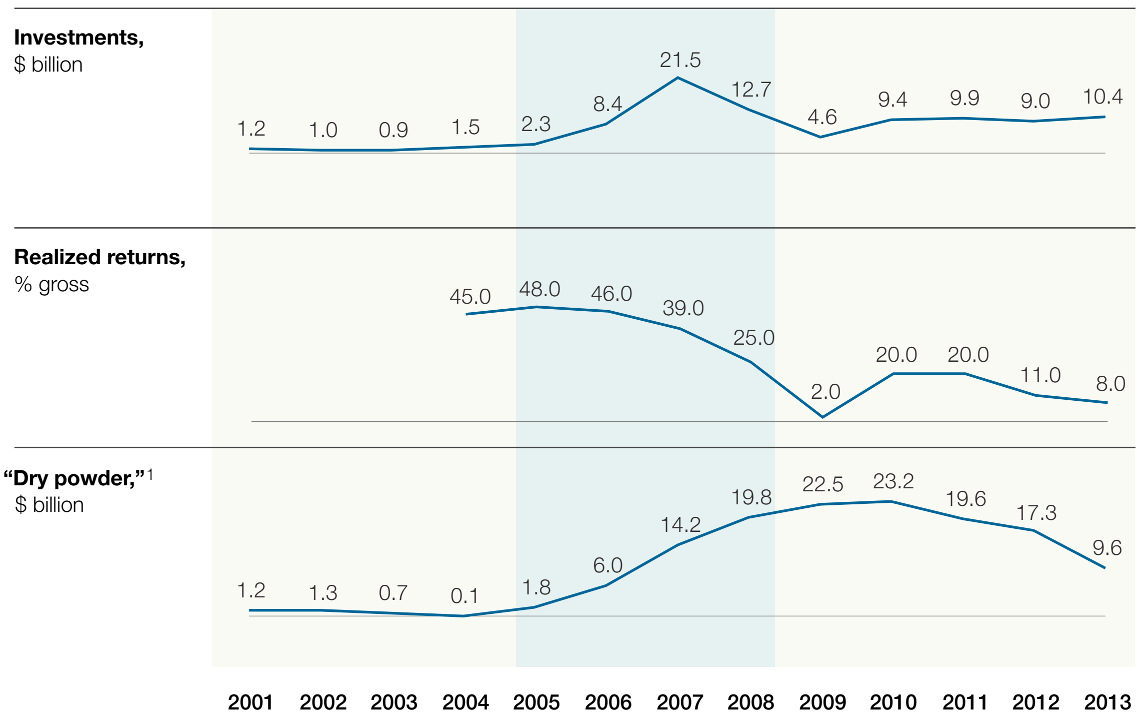
Estimates overshot the mark

Firms overestimated the market in several ways. Some misjudged the investable universe of private companies. The pull of public markets set the stage for some adverse selection of private

Exhibit 1

Indian private equity peaked between 2005 and 2008 and has yet to regain its form.

Private equity in India, 2001–13



[1]Calculated as the difference between trailing 7-year funds raised and investments in India through local and Asia-focused funds.

Source: *Asian Venture Capital Journal*; Preqin; VCCEdge; McKinsey analysis companies and created unexpected competition from intermediaries. Overly optimistic GDP forecasts and a convenient interpretation of PE-to-GDP ratios also worked against some PE firms.

Indian general partners are fishing in a small pond (Exhibit 2). In 2013, India had 10,440 companies with between $25 million and $500 million in revenue, excluding state-owned entities and publicly listed companies; China had 41,150 and Russia had 16,700. And general partners can't step up in size and pursue larger companies; there are about 270 private companies with revenues over $125 million in India, compared with 1,295 in Brazil, 7,680 in China, and 3,430 in Russia. India has about 30 private companies with more than $500 million in revenues.

Indian general partners are in constant competition with stubbornly high capital-market valuations. India has around 2,600 publicly listed companies with less than $125 million in revenue, compared with 1,000 in China. As a result, many private companies went public before PE managers could access them.[1] This had two effects. First, it created pricing pressure on private buyers; indeed, India is one of the few markets where private valuations meet and often exceed public-market comparables. Second, some argue it created an adverse selection of private companies, as companies that could access public markets did.

With fewer investable private companies, competition from capital markets, and growing levels of "dry powder" among PE firms, the

Exhibit 2

India offers fewer private companies than other emerging markets.

Private companies by annual sales,[1] number of companies, 2013

	<$2 million	$2 million–$25 million	$25 million–$125 million	$125 million–$500 million	>$500 million
Brazil	660,000	415,500	1,235	750	545
Russia	1,760,000	258,500	14,100	2,600	830
China	12,400,000	195,500	34,250	6,900	780
India	760,000	99,000	10,200	240	30
		Growth stages			

[1] Does not include public-sector undertakings and other government-sponsored businesses, public companies, or businesses in the unorganized sector.

Source: OneSource; Russian Federation Federal State Statistics Service; McKinsey analysis environment became fertile for sell-side intermediaries, facilitating greater competition. Intermediaries push prices up via auctions, and, of course, public comps underpin the market. As a result, Indian general partners saw a highly intermediated, fully priced market with few proprietary deals.

Rewards for optimism persisted longer than they should have. In every year but one between 2002 and 2010, India's GDP exceeded all major analysts' predictions. However, from 2011 on, that trend reversed sharply as India's GDP came in either below or at the lower end of analysts' expectations. With so many models pegged to GDP growth estimates, volatility played havoc with returns.

India's general partners also had more capital on hand than could be reasonably invested. Many investors were bewitched by industry observers' claims that India's PE-to-GDP ratio was low relative to developed markets. However, a closer look reveals those numbers weren't so low. If cumulative PE investments from 2002 to 2005 relative to 2005 GDP are considered, India stood at 0.72 percent, similar to China (0.85 percent) and below Indonesia (1.08 percent) and Korea (1.15 percent). But as capital flowed in, India quickly hit and passed these benchmarks. The figures for 2006–09 stood at 3.5 percent for India, higher than China (1.2 percent), Korea (2.4 percent), and Indonesia (0.8 percent). True, between 2006 and 2009 private investors sunk nearly $60 billion into China, more than the $47 billion they invested in India. But then again, the Chinese opportunity is much larger—bear in mind the more than 40,000 companies that private investors might access in China, relative to India's 10,000, as shown in Exhibit 2. By the end of 2006, investors in India sat on more than four years of dry powder.

Excess capital pressured discipline

With excess capital on hand, general partners increased transaction sizes and invested in a range of sectors, many of them capital intensive, relatively illiquid, and requiring longer times to exit. As a result, returns have been hurt, exits have been scarce, and secondary sales are becoming much more frequent.

Between 2005 and 2008, firms deployed capital in several industries (Exhibit 3). In the next wave of investment, between 2009 and 2013, the investment mix shifted considerably, and not for the better. For one thing, more investments were directed to sectors that have longer gestation times and are more capital-expenditure intensive, such as engineering and construction, hospitals, power generation, and real estate—in other words, infrastructure plays. In India, such investments are often greenfield and take longer to bear fruit. By 2013, all of the 25 largest firms had at least one such investment in their portfolios, representing 43 percent of the $77 billion invested between 2007 and 2013. In several cases, as bank lending got tighter, inflation rose, and policies wavered, the returns in these sectors dropped, just as firms were committing more capital to them.

Second, many infrastructure investments were made by generalist firms whose capabilities to manage risk and projects with longer exit horizons varied significantly. By contrast, consumer goods accounted for a mere 6 percent of investments in 2005–08 and 5 percent in 2009–13. The expansion of investors' appetite for larger deals came at the same time that several capital-hungry sectors sought capital. But this increased risk, as these sectors were disproportionately affected by escalating input costs and policy-driven delays.

Exhibit 3

Investors allocated more capital to several sectors whose subsequent performance lagged.

Private-equity investments and returns in India, by sector

Infrastructure-related sectors

	Return on invested capital (ROIC), %: 2005–08	Return on invested capital (ROIC), %: 2009–13	% of total private-equity investments[5]: 2005–08	% of total private-equity investments[5]: 2009–13	ROIC minus WACC,[6] %, 2009–13
Information technology	43	39	9	14	26
Real estate[1]	39	6	24	13	–8
Consumer goods[2]	16	13	6	5	1
Financial services[1]	15	14	14	10	1
Engineering and construction[3]	14	10	7	9	–2
Business and consumer services	12	14	3	6	1
Energy and utilities	12	9	4	10	–1
Healthcare providers[3]	10	9	2	6	0
Telecommunications	10	7	14	6	–4
Travel, transport, and logistics	9	6	4	5	–6
Others[4]	13	8	10	16	0

[1]Return on equity and cost of equity have been used for these sectors in place of ROIC.
[2]Consumer goods includes all consumer products, food and beverage, leisure, retail, and textiles.
[3]Also includes related equipment suppliers.
[4]Includes automobiles, machinery and industrial goods, media and entertainment, metals and mining, and pharmaceuticals.
[5]Figures may not sum to 100%, because of rounding. Total investment in 2005–08 was $45 billion and in 2009–13 was $43 billion.
[6]Weighted average cost of capital.

Source: *Asian Venture Capital Journal*; PROWESS (India) Consulting Services; McKinsey analysis

The average investment holding period for exited deals rose from 3.5 years in 2004 to 5.2 years in 2013. Those entering these relatively illiquid long-gestation businesses found it even harder to exit: of the $51 billion in investments made between 2000 and 2008, only 14 percent (by value) of those in real estate exited, along with 29 percent in logistics plays, 21 percent in engineering and construction companies, and 9 percent in energy and utilities (Exhibit 4). Shareholders and promoters found themselves in a tough position as input costs soared, working-capital needs increased, and the IPO market lost its appetite for midmarket listings. In aggregate, only $16 billion

Exhibit 4

Most sectors saw few exits, long holding periods, and low gross returns.

Private-equity performance in India, by sector

	Investments, 2000–08, $ billion	**Exits,** % of total investments exited, 2000–13	**Gross return of exits,**[1] %	**Holding period of deals exited,** years, 2000–08
Real estate	9.8	14	2	5.3
Telecommunications	7.2	25	5	4.2
Financial services	7.2	34	13	4.4
Information technology	5.9	39	21	4.4
Engineering and construction[2]	3.3	21	16	4.0
Consumer goods[3]	2.8	21	18	3.8
Travel, transport, and logistics	2.0	29	6	4.1
Energy and utilities	1.9	9	N/A[4]	3.7
Business and consumer services	1.6	28	18	3.7
Healthcare providers[2]	1.0	39	19	4.9
Others[5]	8.2	69	0	4.3

Average

[1]Gross dollar internal rate of return estimated for ~610 exits, assuming all investments as 100% equity deals.
[2]Also includes related equipment suppliers.
[3]Consumer goods includes all consumer products, food and beverage, leisure, retail, and textiles.
[4]Fewer than 10 exits observed.
[5]Includes automobiles, machinery and industrial goods, media and entertainment, metals and mining, and pharmaceuticals.

Source: *Asian Venture Capital Journal*; PROWESS (India) Consulting Services; McKinsey analysis

(31 percent) of the $51 billion invested has exited, at a value of $27 billion (Exhibit 5). While several general partners have successfully renegotiated extensions with limited partners, these forces can be expected to have a material impact on returns.

Like many emerging markets, India is prone to momentum investing, with few contrarians to be found. More than 70 percent of private investments in the past ten years were made when the index traded above its ten-year median price-to-earnings multiple of 17.4 (Exhibit 6). By contrast, firms in China deployed less than 50 percent of their capital at times of high valuation. In India's volatile lending environment, promoters learned to raise capital when capital is plentiful. Discussions with general partners reveal a perception of unrealistic price expectations

Exhibit 5

Of $51 billion invested from 2000 to 2008, $16 billion exited at 1.7x, or a value of $27 billion.

Investment period	Investment, $ billion	Exits, cost basis, $ billion	Exits, value basis, $ billion	Exit to entry, multiple
2000–04	5.8	3.3	8.5	2.6
2005–08	45.1	13.0	18.7	1.4
2009–13	43.1	2.0	3.1	1.7[1]

[1]Figures may not sum, because of rounding.
Source: *Asian Venture Capital Journal*; Preqin; VCCEdge; McKinsey analysis

and overpriced investments in others' portfolios. In a market that should prize liquidity, capturing liquidity premiums remains difficult.

With pressure to find an exit mounting, sales to other PE buyers are now the second-largest way out. Nearly 30 percent of all exits by value in 2012–13 were sponsor-to-sponsor sales, up from 10 percent in 2010–11 and 5 percent in 2006–07. The good news: PE-backed companies appear to be better governed and managed. However, they do not come with a buy-back guarantee. One prominent recent sponsor-to-sponsor deal wound up a total loss, with lawsuits filed against the promoter and auditor.

What might go right

For all these flaws, PE has grown to become a critical source of capital in the Indian economy. PE firms are responsible for 36 percent of the equity raised by companies in the past ten years and contribute even more when times are tough—47 percent in 2008 and 46 percent, on average, from 2011 to 2013. Further, our ongoing research suggests that PE-backed companies in India increased revenue and earnings faster than public companies across nearly all sectors and vintages, and these companies are, on balance, better governed, more compliant with respect to regulatory and fiduciary obligations, more likely to pursue M&A, and better at seizing export opportunities.

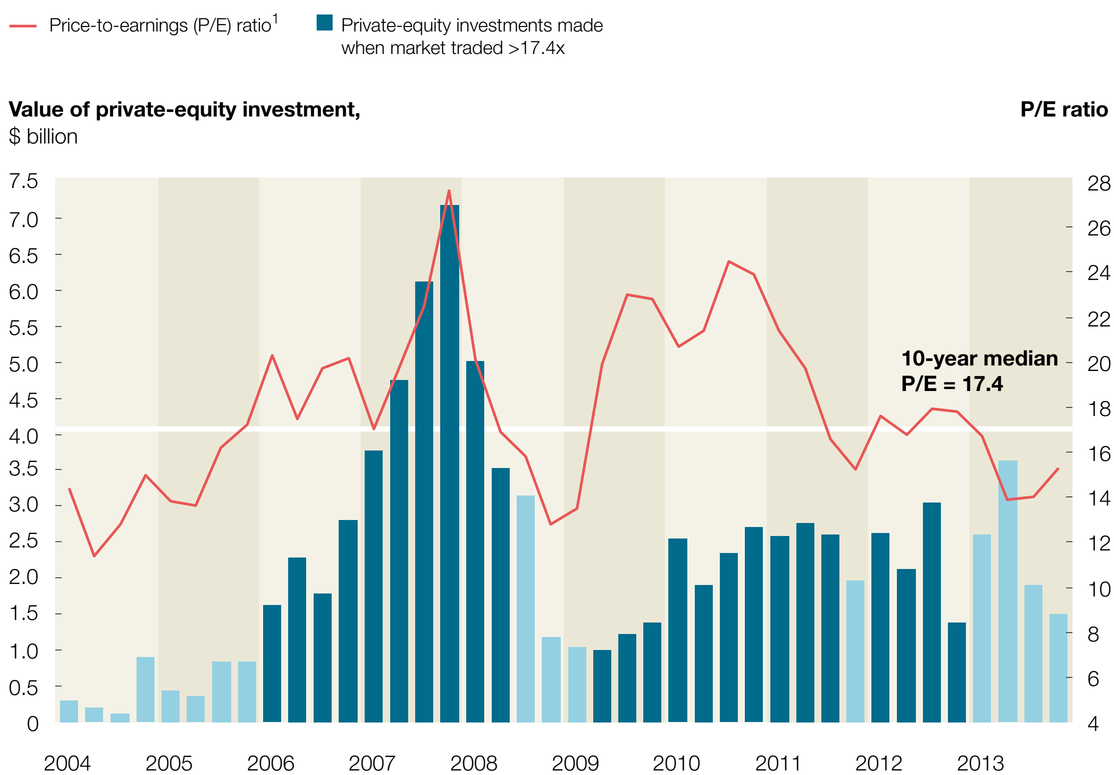
PE investors are clearly doing something right, and they can build on this. Once investors set their sights appropriately and govern behavioral excesses, they can begin to invest in an India that is paradoxically underserved. There are five supports that might emerge for a new wave of growth and returns: an increasing bias toward control deals, a recognition of the complex needs of family-owned businesses, new supply to meet a large and unaddressed need for mezzanine financing and capital restructuring, greater limited-partner scrutiny of general-partner strategies with track records, and support from regulators to boost the confidence of foreign and domestic investors.

As they look for new targets, PE firms can seek more opportunities to exercise control. In 2006–07, 13 percent of Indian PE investments by value were control investments. By 2013, this had increased to 29 percent—a favorable trend. Control investments allow firms to support an aging generation of entrepreneurs, ensure better capital discipline in portfolio companies across volatile cycles, and facilitate easier exits so that firms can renew maturing portfolios. A recent McKinsey survey of Indian general partners revealed capital discipline was the second most important focus after management capabilities.

Many of India's aging owners have succession problems, underscoring the need to address the issues of family-owned businesses. An estimated 70 percent by volume of PE investment from 2007 to 2013 (46 percent by value) went into family-owned businesses. Firms that build a deeper appreciation of the complex needs of these businesses, including the dynamics that affect succession,

Exhibit 6

Seventy percent of investments (~$65 billion) were made during capital-market peaks.



[1]P/E is defined as current market capitalization divided by 12-month trailing earnings for top 200 Indian companies.

Source: *Asian Venture Capital Journal*; Datastream; McKinsey analysis

Our ongoing research suggests that PE-backed companies in India . . . are, on balance, better governed, more compliant with respect to regulatory and fiduciary obligations, more likely to pursue M&A, and better at seizing export opportunities.

talent attraction, family trusts, liquidity, and governance, can bring significant value to their investments and align the interests of promoters more easily. Investors confronted with issues in their family-owned-business investments need to act on early-warning signs and work through them in an orderly fashion to minimize impact on companies' health and performance. In the diligence phase, placing an equal emphasis on the business and on the promoter and management can help firms anticipate governance issues. In a recent McKinsey survey of portfolio-company promoters, general partners and portfolio companies identified the inability to recognize and navigate family issues as a weakness of general partners.

Private equity can also benefit from greater specialization—in particular, in mezzanine capital and distressed debt. The need for mezzanine and bridge financing can be estimated at between $18 billion and $24 billion by 2020; demand for distressed-debt services will likely be even higher. Given the rapid pace of expansion, including more cross-border acquisitions and the on-again, off-again nature of bank lending to companies, more mezzanine and bridge capital would serve promoters well.

With nonperforming corporate loans rising fast at India's banks and more corporate-debt-restructuring cases landing on the books of state banks (which do not always have strong work-out capabilities), there is a strong case for more distressed-debt funds. Many companies have problems in their capital structure, and PE players have the skills for efficient restructuring.

However, both mezzanine and distressed-debt funds need regulatory support. For this to take off, regulators would have to develop an appreciation of mezzanine debt, as they do equity risk capital. In doing so, they would need to expedite court receivership and delisting processes.

Some regulatory reform is needed to enable greater foreign and domestic PE participation. At the top of the list are providing clarity and parity on tax treatment for foreign and domestic funds (including issues such as pass-through status and capital gains), addressing restrictions on investment in certain sectors and on issuing convertible bonds, increasing the investable pool by simplifying the delisting process, encouraging distressed debt and mezzanine financing, simplifying fund-registration requirements, and recognizing the difference between traditional promoters and active investors. While these reforms have been on the table for a few years, many hold out hope that the new government will see some of them through.

Limited partners also have a role to play in seeing PE expand; they can do better at general-partner selection. Experience matters and is on the rise. Of the 113 funds that invested between 2000 and 2013, 33 are now inactive. The vast majority of these were first timers. The sector is slowly maturing; the number of funds investing from a third (or successive) fund increased from 5 in 2003 to 22 in 2013. As limited partners increase selectivity, further consolidation and increased discipline are anticipated.

• • •

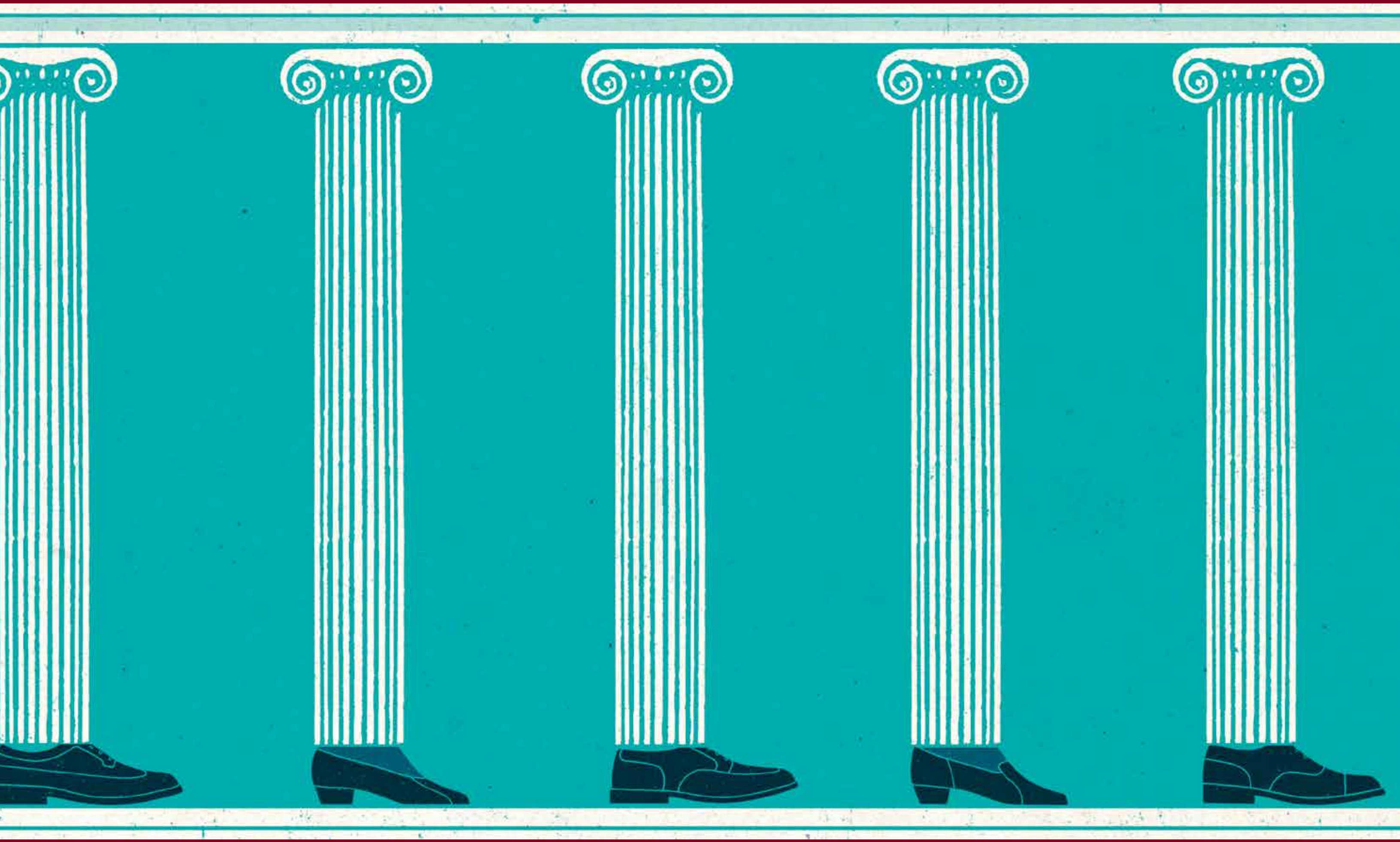
The industry is well positioned for a new era of growth and returns if PE investors gain greater control, develop active-ownership capabilities, and can identify and align family and promoter interests, and if regulators recognize that investors can deliver more than money across the capital structure.

[1] In 2013, India had nearly 3,800 publicly listed companies; their median revenues were $20 million and mean revenues were $330 million. By contrast, China had 3,600 public companies, whose median revenues were $240 million and mean revenues were $1.6 billion. The figures for Brazil's 325 public companies were $490 million in median revenues and $2.5 billion in mean revenues.

The author wishes to thank Udit Anand, Souvik Chakraborty, and Yashashvi Takallapalli for their contributions to this article.

Vivek Pandit (Vivek_Pandit@McKinsey.com) is a director in McKinsey's Mumbai office.

Institutional investing



Dan Page

51
From indexes to insights: The rise of thematic investing

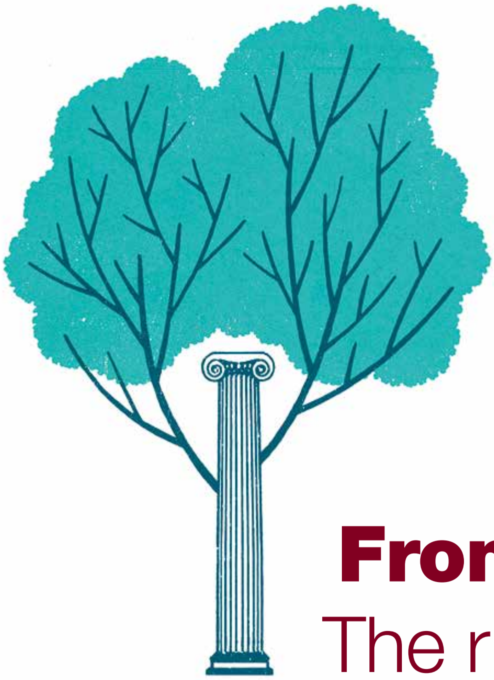
Vincent Bérubé, Sacha Ghai, and Jonathan Tétrault

57
What overachieving institutional investors get right

Sacha Ghai, Ju-Hon Kwek, and Danish Yusuf

61
Investing for the long term

Dominic Barton and Mark Wiseman



From indexes to insights:
The rise of thematic investing

Leading institutions say this new approach can deliver better performance over the long term than their traditional methods. Here's how they're putting it in place.

Vincent Bérubé, Sacha Ghai, and Jonathan Tétrault

Over the past few years, a number of structural economic changes—a persistent bout of historically low interest rates, the polarization of growth between developed countries and emerging economies, and global deleveraging—have had an impact on how institutional investors deploy capital. The "metabolic rate" of the economy is also accelerating, with industry dynamics evolving faster than ever and profit pools shifting across value chains in many industries, thanks to unprecedented technological innovations.

In this challenging environment, many institutional investors have started to question their traditional "relative investment" frameworks, which are structured around either adhering to or deviating from benchmarks and indexes. These frameworks often fail to achieve the specified rate of absolute return for three reasons. First, the short-term focus of quarterly benchmarking works against one of institutional investors' great advantages, their long-term investment horizon. A zealous focus on the benchmark means investors can miss chances to capture mispriced assets; they can also miss out on the liquidity premium, which they collect by buying illiquid long-term assets at a discount. Second, relative-investment frameworks can lead to an undesirable exposure to certain risks. Finally, the very nature of the strategic asset-allocation process used to select benchmarks also holds investors back. Strategic asset allocation is backward looking and fails to incorporate emerging trends and forward-looking perspectives on the economy.

To meet their absolute-return targets, many institutional investors are therefore starting to complement relative investing with a number of "absolute focused" investment strategies, which can take the form of a greater allocation to illiquid asset classes, concentrated portfolios, or relationship-investing strategies, among other options.

In addition, many are turning to "thematic" investment strategies. That was the most intriguing insight we took from a series of interviews we conducted in 2013 with about a dozen pension funds, sovereign-wealth funds, and other institutional investors. Broadly speaking, thematic-investment approaches seek to capture, across asset classes and around the world, the opportunities created by long-term structural trends and the medium-term cyclicality often associated with these trends. Some investors have deployed thematic strategies for years; they appreciate the way these allow them to actively manage risk and ensure that their capital is deployed against the opportunities that best reflect their investment convictions. However, many institutions have not yet taken advantage of such approaches. In this article, we outline a process that some investors are using to develop and execute thematic-investing strategies.

Demystifying thematic investing

Thematic investing requires a fundamental understanding of the impact of long-term economic, political, and social trends on regions and sectors, which reveals investable opportunities. Thematic investors develop proprietary views on how the second- and third-order effects of structural trends will create hot spots or discontinuities in certain sectors and regions where value and risk will be concentrated. This is a big departure from relative strategies; Exhibit 1 illustrates some of the differences.

Adopting a thematic-investing approach can yield three types of benefits for investors. First, it allows investors to generate alpha at scale by focusing on investment opportunities in hot spots where a significant amount of capital can be deployed. Second, the more systematic investment process and in-depth research required for thematic investing builds a deeper understanding of the underlying drivers of value creation and risk; investors can use this knowledge not just in thematic investing but also in other strategies. Third, it provides investors with a dynamic and flexible way to validate and express their hunches by applying a forward-looking lens to investment decisions.

Investors have long been aware of thematic investing, but many thought it too complex to implement because of restrictive portfolio structures, risk limits, and the challenge of putting in place the capabilities and processes needed to develop truly distinctive investment insights. In recent years, however, a number of investors have taken tactical and creative approaches to implement some form of thematic investing, usually as an addition to their overall investment framework. Exhibit 2 illustrates four of these approaches. It should be noted that newcomers to the strategy tend to allocate a significant portion of their active risk budget to it. This gives them the same total risk budget as before—though the risk profile may shift as a result of more concentrated and less liquid investments—but focuses it on opportunities that are more aligned with their convictions.

Embarking on the journey

The ability to fold a thematic strategy into a relative-investing framework is good news for investors that have held back because they did not wish to completely overhaul their approach and their portfolio. But it still requires the right research capabilities and a disciplined investment process. Our focus here is on the latter.[1]

A structured and rigorous approach is required not only to identify investable themes but also to prioritize them. The following five-step approach does both and has been implemented by a number of leading thematic investors.

Exhibit 1

Relative and thematic frameworks differ in several dimensions.

	Relative framework	Thematic framework
Asset allocation	Asset classes as building blocks	Sector and country exposure as building blocks (matrix view)
Portfolio construction	Weight of asset classes in portfolio based on economic cycles and market conditions	Selection of themes, sectors, or regions across asset classes based on underlying market trends
Alpha generation	Based on security selection relative to an index	Based on selecting groups of companies that will benefit from long-term support of structural trends
Decision process	Portfolio managers allocate capital within defined mandates	Investment committee arbitrages opportunities across themes
Investment performance	Measured relative to an index (typically on an annual basis)	Measured against an absolute target or a risk-adjusted index (over a 3- to 5-year rolling history)
Expertise	Investment professionals with experience in a given asset class or sector	Investment professionals with a combination of in-depth regional and sector experience across asset classes
Research	Typically occurs within portfolios, with research performed at security level	Central group develops house views on priority themes and opportunities for institution

1. Consider the trends

Identifying the right trends to consider is essential. At this early stage, investors should hold broad internal dialogues to make sure all relevant trends are considered and to gain agreement on the rationale that will be used to prioritize and ultimately select some for more research.

A few factors are important to consider when prioritizing trends. First, is the trend really structural, or is it conjectural or short-term in nature? Does it have material implications for the evolution of certain sectors or regions? Second, does the institution have the ability to generate distinctive insights about that specific trend and

Exhibit 2

Institutions are using a range of approaches to develop thematic-investing strategies.

Lower commitment to thematic strategy

Approach	Example
Develop thematic views within existing structure Develop and implement thematic investments within the risk limits and structure of the current portfolio	Use current risk limits in an international equity portfolio to increase exposure to specific solar-module producers in response to a renewable-energy theme
Put in place a thematic overlay From the center, establish a thematic-overlay portfolio or shift asset allocations and increase their duration based on house views on sector/geography	Gain long-term exposure to wheat price by investing in wheat futures as part of a thematic-overlay portfolio
Create a single-asset-class thematic mandate Allocate capital to portfolios or mandates with investment strategies that rely on developing forward-looking thematic views	Create and capitalize an equity portfolio with a clear purpose of gaining long-term exposure to renewable energy
Create a multiasset-class thematic mandate Create a thematic fund to generate the most attractive long-term risk-adjusted returns by investing in various asset classes	Create a portfolio—governed by a multiasset-class committee—looking into technology investments through a combination of venture-capital funds, direct private-equity investments, and public-equity positions

Higher commitment to thematic strategy

identify sufficient investment opportunities? Third, are research and investment professionals excited about the trend and willing to invest time looking into it?

At this stage, investors should also develop a robust view of the institution's explicit and implicit exposure to the selected trends before adding more long-term risk to the portfolio. For instance, an Australian investor may not own shares in companies serving the rising middle class in China, yet a commodity-filled Australian equity benchmark can significantly expose that same investor to a slowdown in Chinese consumerism. In a nutshell, investors must ensure that they understand their true exposure—both direct and indirect—to these trends before conducting additional analyses and seeking greater exposure.

2. Move from trends to themes

Once key trends have been selected, investors must trace them through to the themes they produce, typically the implications for a region or sector of interest. While the increased consumption of food in emerging markets is a powerful trend, for example, the changing market for dairy protein in China is a theme that can be realistically investigated for opportunities. In our experience, the most attractive opportunities are found when multiple themes converge and reinforce one another in a specific region or sector and when themes are expressed as discontinuities and divergences from common knowledge.

The identification of relevant themes depends on investors' ability to rapidly identify the effects of a trend on revenues and profit pools in affected subsectors. Making sense of vast amounts of information and identifying new economic patterns in it is notoriously difficult. Most successful investors use external experts as thought partners and sounding boards to supplement their internal knowledge. Our experience also suggests that investors that can rapidly move from interesting trends to themes before trying to identify specific investment opportunities move faster, get more impact from their research investment, and develop more detailed insights.

3. Select themes

Prioritizing themes is even more challenging, as investors must make decisions based on imperfect information and diverging points of view within the institution. The process can be time consuming and frustrating without the right approach but rapid and effective if appropriately designed.

To be successful at this important stage, institutions typically agree first on simple criteria based on their risk/return profile and capabilities to invest in a distinctive way. This boils down to four questions that should be asked about each theme:

- Is the theme investable? Investors should assess the high-level attractiveness of the theme and make sure there are ways to deploy capital against it at the ground level. Are there companies whose businesses are heavily exposed to the theme? Are there other assets that might do well if the theme materializes? Can potential investments be made without running excessive risk?

- What is the risk that the theme will not materialize? The focus should be on countervailing forces and what they might mean for a potential investment. Investors typically try to avoid binary outcomes, as they present higher risks.

- Does the institution have the capabilities to differentiate itself? Factors such as distinctive knowledge, market access, a superior understanding of the assets and their value chains, and existing relationships with or privileged access to the right partners should all be considered.

- Does the theme fit within the current portfolio construction and investment policies? Choosing themes whose potential investments can be easily integrated and monitored within the investment structure enables investors to move rapidly and focus on building capabilities rather than addressing governance issues.

Themes should be debated and prioritized by representatives from the investment, research, and risk teams to ensure both the soundness of the thinking and the alignment of the theme with the overall corporate perspective. This will prevent thematic portfolios from becoming vehicles for individuals to place large bets based on their personal biases.

4. Develop an investment thesis

Once priority themes have been identified, investors must form an investment thesis describing how and why value could be created from these themes over time. This typically involves two stages. First, investors develop an understanding of the value chains associated with a given theme, including the key players, industry dynamics, and performance drivers. Next, they develop a perspective on how industry dynamics will be altered by the theme, forcing players to adapt and creating winners and losers.

To be successful at this stage, investors must first ensure that their thesis is clear, grounded in objective facts, and based on themes that have a high degree of probability of materializing. Second, they must find insights into business systems beyond those most directly affected by the theme. For example, an investor looking into the impact on the transportation sector of populations migrating to suburbs from large city centers may determine that the best investment opportunity will be in the manufacturers of batteries that will power light trains rather than in the transportation companies themselves or in the related infrastructure.

5. Build the portfolio

With a clear investment thesis in mind, investors can start a "scan and screen" process across asset classes to find the best ways to take a position in the theme. Several characteristics mark the most distinctive investors at this stage:

- a clear perspective on the factors that will lead to success (that is, a concrete understanding of how value will be created and in what time frame)

- a list of potential targets that is systematically assessed against the success factors and monitored over time to find the right entry (and exit) points

- a selection of investments that have both high exposure to the theme and solid industry fundamentals to offset the potential long-term nature of the investment and the risk that the theme will take time to materialize

- a clear investment approach—likely a set of discrete investments, a portfolio of related assets, or a platform for operations and subsequent roll-up acquisitions

Finally, depending on the size of the portfolio and the number of investments it includes, additional consideration might be given to the level of correlation of the various assets, as well as the key sensitivities of specific thematic risk factors.

• • •

Thematic investing provides an alternative to traditional strategies—one that leverages the greatest strengths of institutional investors while providing the opportunity to develop proprietary knowledge and informed opinions. By understanding implicit sector exposures and then determining where and how to invest based on well-researched and debated themes, institutions increase their chances of delivering superior returns over time in an increasingly complex investment landscape.

[1] Regarding research, we heard from our interviewees that thematic investors are shifting the emphasis of their sector experts from following companies to understanding sector dynamics. They are also finding new ways to combine sector and macroeconomic perspectives.

Vincent Bérubé (Vincent_Berube@McKinsey.com) is a principal in McKinsey's Montréal office, where **Jonathan Tétrault** (Jonathan_Tetrault@McKinsey.com) is a director; **Sacha Ghai** (Sacha_Ghai@McKinsey.com) is a director in the Toronto office.

What overachieving institutional investors get right

No single practice or behavior explains success. Instead, top investors work across five dimensions to achieve excellence.

Sacha Ghai, Ju-Hon Kwek, and Danish Yusuf

We recently examined the performance of 40 of the world's largest institutional investors from 2004 to 2011. Conventional wisdom led us to expect that the firms with the highest rewards would also have taken the greatest risks. But it turns out that a number of "underachievers" had good but highly volatile returns, while a group of "overachievers" managed to generate virtually the same returns with half the volatility. On average, overachievers returned 8.1 percent annually and lost 16.1 percent during the 2008–09 crisis. (We use losses in these years as an indicator of the amount of risk that investors take on.) Underachievers managed a slightly higher annual return, 8.7 percent, but suffered much greater crisis losses, 23.8 percent.

To understand what might cause this disparity in performance, we interviewed more than 100 senior leaders from the overachieving firms. We found there is no single best-practice approach to "running money." Instead, these top investors owe their performance to an ability to align their organization and management approach across five key areas: the mandate, the governance model, the investment philosophy, the investment strategy and processes, and talent management (exhibit). These are the core pillars supporting successful institutional-investing platforms that create outsize value over time. Institutional investors that take a holistic approach to these pillars create a positive climate for strong investment management that is aligned with their specific missions.

For the top performers, however, this is just the starting point. Overachievers also ensure that the pillars are aligned, consistent, and self-reinforcing; that day-to-day practices are in line with each pillar; and that the pillars are designed to evolve as the institution grows and matures.

The choices each institutional investor faces with these pillars will be determined by its stakeholders, priorities, and operating environment. Yet all investors can benefit from a careful, disciplined analysis of their operating model along each of the five pillars. This type of analysis enables investors to create road maps for the evolution of their

Exhibit

High-performing institutional investors build their organization on five pillars.

	1 Mandate	2 Governance model	3 Investment philosophy	4 Investment strategy and processes	5 Talent management
Key dimensions	Mission Investment constraints	Governance Policies, guidelines, and procedures Decision rights	Core beliefs Asset-class investment principles	Asset allocation Investment strategies Portfolio structure External-manager selection process Organizational structure	Investment and support-function structure Talent Compensation/incentives Culture
Common features	Explicit mission providing guidelines with respect to long-term objectives and constraints	Oversight structure and policies ensuring long-term sustainability	Clear investment philosophy articulated by a resolute leadership team	Flexible and cost-effective investment strategy to exploit competitive advantages	Direct alignment of mandate, philosophy, strategy, organization, and compensation

Source: McKinsey analysis

institutions in alignment with their visions of the future. Here, we briefly touch on the critical practices for each pillar.

The mandate

The investment mandate sets the direction for the entire institution. Yet, all too often, the mandate does not receive sufficient attention until serious violations occur, such as excessively risky investments or significant conflicts of interest. The best institutional investors ensure their mandates are clear and concise and guide everything from investments to performance management and governance. Typically, these mandates define the institution's overall purpose, and they provide high-level guidance on how to balance risk and return. They also outline the institution's approximate time horizon for investments given its purpose and how it will interact with its beneficiaries.

The governance model

Like the mandate, governance is a function that is rarely discussed when it is working well, but it can drag performance down when issues arise. For institutional investors, effective governance can be particularly challenging because of a number of complicated factors, especially the potentially conflicting goals of different stakeholders—for example, in jointly sponsored pension plans with government and union board members.

The large institutional investors we surveyed achieve optimal governance by adhering to four principles: clear accountabilities, board competence, efficient decision making, and effective fiduciary control.

The investment philosophy

An investment philosophy guides the development of a tactical investment strategy. The philosophy should be closely tied to the mandate and reflect the institution's core beliefs about the markets. For example, a pension plan may establish the minimization of risk and a focus on cash generation as philosophical principles. Well-constructed philosophies typically share five elements: a statement of market beliefs, a similar framing of asset-class beliefs, a fund-management style, a risk appetite, and a position on diversification.

The investment strategy and processes

Leading institutional investors ensure their investment strategies and processes flow naturally from their philosophies. The strategy, often framed as an investment policy, influences the asset allocation, outlines a specific strategy for each asset class (for instance, setting benchmarks for returns and specifying internal or external management), and defines the support organizations' structures, all of which are tightly aligned since they are highly interdependent.

The best institutional investors carefully design the investment organization to support their investment philosophies. For example, a philosophy that uses external managers for illiquid assets and internal managers for liquid assets would require a well-defined bipartite structure. The externally managed asset classes likely would report to a dedicated head, while the internally managed asset classes could report directly to the chief investment officer. Risk management is a critical part of the structure; leading investors view it as a value-adding partner to the business rather than as a control function.

Overachieving investors review both strategy and structure periodically. Typically, they monitor customer needs through interviews or surveys to ensure a responsive and aligned structure, and they pressure test the support structure against the

The best institutional investors ensure their mandates are clear and concise and guide everything from investments to performance management and governance.

overall organizational strategy (for instance, by managing for the lowest possible cost rather than considering quality first and cost second).

Talent management

Talent is at the core of any high-performing organization—and that is especially true for institutional investors. Senior leaders at world-class investment institutions spend a disproportionate amount of time and effort on recruiting, developing, and retaining talent. Underlying all world-class talent-management systems is a set of unique benefits that accrue to the people in the organization. The most successful public pensions and sovereign funds, for example, base their value propositions to employees on the higher purpose of furthering a social good (such as helping pensioners) or on a broader national objective (such as increasing national economic resilience). Many with direct-investment capabilities explicitly offer employees the opportunity to be true value investors, with the ability to deploy "patient" capital with minimal constraints.

Compensation, in contrast, hardly ever takes a leading role in the employee value propositions of leading institutional investors—even for the few that are unconstrained in their ability to pay top dollar to attract top talent. And although compensation, like many of the other topics we've touched on here, has complexities that can bedevil many investors, leaders find a way through the complexities.

The authors wish to thank Jonathan Tétrault for his contributions to this article.

Sacha Ghai (Sacha_Ghai@McKinsey.com) is a director in McKinsey's Toronto office, where **Danish Yusuf** (Danish_Yusuf@McKinsey.com) is an associate principal; **Ju-Hon Kwek** (Ju-Hon_Kwek@McKinsey.com) is a principal in the New York office.

Investing for the long term

Dominic Barton, McKinsey's global managing director, and Mark Wiseman, president and CEO of Canada's largest pension fund, explain why big investors are crucial to ending the plague of short-termism.

Dominic Barton and Mark Wiseman

The tension between "quarterly capitalism" and managing for the long term is growing sharper. In 2013, McKinsey and the Canada Pension Plan Investment Board (CPPIB) surveyed more than 1,000 board members and C-suite executives around the world to assess their progress in taking a longer-term approach to running their companies. The results are stark:

- Sixty-three percent of respondents said the pressure to generate strong short-term results had increased over the previous five years.
- Seventy-nine percent felt especially pressured to demonstrate strong financial performance over a period of just two years or less.
- Forty-four percent said they use a time horizon of less than three years in setting strategy—while seventy-three percent said they should use a time horizon of more than three years.
- Eighty-six percent declared that using a longer time horizon to make business decisions would positively affect corporate performance in a number of ways, including strengthening financial returns and increasing innovation.

What explains this persistent gap between knowing the right thing to do and actually doing it? About half of the executives surveyed said that the pressure to deliver strong short-term financial performance stemmed from their boards—but the board members made it clear that they were often just relaying increased short-term pressures from investors, including institutional shareholders.

That's why we have concluded that the single most realistic and effective way to move forward is to seek change in the investment strategies and approaches of the players who form the cornerstone of our capitalist system: the big asset owners, who today own 73 percent of the top 1,000 companies in the United States, versus 47 percent in 1973. In this article, we will briefly review the problems with short-termism and discuss practical approaches that investors are deploying to focus on the long term.

Practical changes for institutional investors

With few exceptions, big investors are not taking a long-term approach in public markets. They do not routinely engage with corporate leaders to shape the company's long-range course. They use short-term investment strategies designed to track closely with benchmark indexes like the MSCI World Index. And they let their investment consultants pick external asset managers who focus mostly on short-term returns. To put it bluntly, they are not acting like owners.

The result has been that asset managers with a short-term focus are increasingly setting prices in public markets. They take a narrow view of a stock's value that is unlikely to lead to efficient pricing and collectively leads to herd behavior, excess volatility, and bubbles. Work by Andrew G. Haldane and Richard Davies of the Bank of England has shown that stock prices in the United Kingdom and the United States have historically overdiscounted future returns by 5 to 10 percent.

Avoiding the pressure for short-term results is a big reason why private-equity firms take public companies private. With that freedom, they can achieve better performance over time. Research, including an analysis by CPPIB, indicates that over the long term (and after adjustment for leverage and other factors), investing in private equity rather than comparable public securities yields annual aggregate returns that are 1.5 to 2 percent higher, even after substantial fees and carried interest are paid to private-equity firms. Other research pegs the private-equity performance premium even higher.

Short-termism undermines the ability of companies to invest and grow, which ought to concern investors. Those missed investments, in turn, have far-reaching consequences, including slower GDP growth, higher unemployment, and lower return on investment for savers. To reverse this destructive trend, we suggest four practical approaches for institutional investors serious about focusing more capital on the long term.

Invest the portfolio after defining long-term objectives and risk appetite

Many asset owners will tell you they have a long-term perspective. Yet rarely does this philosophy permeate all the way down to individual investment decisions. To change that, the asset owner's board and CEO should start by defining exactly what they mean by long-term investing and what practical consequences they intend. The definition needs to include a multiyear time horizon for value creation. For example, Berkshire Hathaway uses the rolling five-year performance of the S&P 500 as its benchmark to signal its longer-term perspective.

Just as important as the time horizon is the appetite for risk. Short-term underperformance should be tolerated—indeed, it is expected—along the road to greater long-term value creation. Singapore's sovereign-wealth fund, GIC, maintains a 20-year horizon for value creation. Since the mid-2000s, it has pursued long-term growth by placing up to one-third of its investments in a range of public and private companies in volatile Asian markets. This has meant that during developed-market booms, its equity holdings have underperformed global equity indexes. While the board looks carefully at the reasons for those results, it tolerates such underperformance within an established risk appetite.

Next, management needs to ensure that the portfolio is actually invested in line with its stated time horizon and risk objectives. This will likely require allocating more capital to illiquid or "real" asset classes like infrastructure and real estate. It may also mean giving much more weight to strategies within a given asset class that focus on long-term value creation, such as "intrinsic value–based" public-equity strategies, rather than momentum-based ones. Since its inception in 1990, the Ontario Teachers' Pension Plan (OTPP) has been a leader in allocating capital to illiquid long-term asset classes as well as making direct investments in companies. Real assets, such as water utilities and retail and office buildings, account for 21 percent of OTPP's portfolio. Another believer in this approach is the Yale University endowment fund, which began a self-proclaimed "revolutionary shift" to nontraditional asset classes in the late 1980s. Today the fund has just over 31 percent of its portfolio in private equity and 19 percent in real estate.

Finally, asset owners need to make sure that both their internal investment professionals and their external fund managers are committed to this long-term investment horizon. The conventional "2 and 20" arrangement does little to reward fund managers for long-term investing skill. Annual cash payments still make up three-quarters of fund managers' compensation, according to a recent Ernst & Young survey. Yet, rather than simply reducing fixed management fees, encouraging a long-term outlook should be the focus. CPPIB has been experimenting with a range of novel approaches, including offering to lock up capital with public-equity investors for three years or more, paying low base fees but higher performance fees if careful analysis can tie results to truly superior managerial skill (rather than luck), and deferring a significant portion of performance-based cash payments while a longer-term track record builds.

Unlock value through engagement and active ownership

The typical response of many asset owners to a failing corporate strategy or poor environmental, social, or governance practices is simply to sell the stock. Thankfully, a small but growing number of leading asset owners and asset managers have begun to act much more like private owners and managers who just happen to be operating in a public market. To create value, they engage with a company's executives—and stay engaged over time.

Such engagement falls along a spectrum, with varying levels of resources and commitment required. Investors with stakes of only 1 or 2 percent cannot go it alone as easily and need to act as necessary alongside other investors. Other investors may seek stakes of 10 percent or more with a deliberate strategy to win a board seat and work with management on long-term strategy. But all asset owners can find ways to engage, either individually or in small coalitions with other like-minded investors.

Some asset owners are large enough to engage on their own by dedicating capital to a relationship-investing strategy. This could involve taking a significant stake (10 to 25 percent) in a small number of public companies, expecting to hold those for a number of years, and working closely with the board of directors and management to optimize the company's direction. For smaller asset owners, independent funds like ValueAct Capital and Cevian Capital provide a way to pool their capital in order to influence the strategies of public companies. The partners in such a coalition can jointly interact with management without the fixed costs of developing an in-house team.

Engaging with companies on their long-term strategy can be highly effective even without acquiring a meaningful stake or adopting a distinct, formal investment strategy. The California Public Employees' Retirement System (Calpers) screens its investments to identify companies that have underperformed with respect to total stock returns and fallen short in some aspect of corporate governance. It puts these companies on its Focus List—originally a published list but now an internal document—and works with management and the board to institute changes in strategy or governance. Several studies have concluded that companies on the Focus List outperform peers. Interestingly, the companies Calpers worked with privately outperformed those named publicly, so from 2011 onward, Calpers has concentrated on private engagement.

Despite the evidence that active ownership is most effective when done behind the scenes, there will inevitably be times when public pressure needs to be applied to companies or public votes have to be taken. In such cases, asset owners with sufficient capacity should go well beyond following guidance from short term–oriented proxy advisory services. Instead, they should develop a network with like-minded peers, agree in advance on the people and principles that will guide their efforts, and thereby position themselves to respond to a potentially contentious issue with a company by quickly forming a microcoalition of willing large investors. That approach worked well recently for a microcoalition of owners alongside a long term–oriented hedge fund with stakes in Canadian Pacific.

Demand long-term metrics from companies

Making long-term investment decisions is difficult without metrics that calibrate, even in a rough way, the long-term performance and health of companies. Focusing on metrics such as ten-year economic value added, R&D efficiency, patent pipelines, multiyear return on capital investments, and energy intensity of production is likely to give investors more useful information than generally accepted accounting principles in assessing a company's performance over the long haul. The specific measures will vary by industry sector, but they exist for every company.

Some companies already publish such metrics. Natura, a Brazilian cosmetics company, is pursuing a growth strategy that requires it to scale up its decentralized door-to-door sales force without losing quality. To help investors understand its performance on this key indicator, the company publishes data on sales-force turnover, training hours per employee, sales-force satisfaction, and salesperson willingness to recommend the role to a friend. Similarly, Puma, a sports lifestyle company, recognizes that its sector faces significant risks in its supply chain, and so it has published a rigorous analysis of its multiple tiers of suppliers to inform investors about its exposure to health and safety issues through subcontractors.

But at other companies, asset owners need to encourage management to shift time and energy away from issuing quarterly guidance and toward metrics that correspond to long-term value creation. In pursuing this end, they can work with industry coalitions that seek to foster wise investment, such as the Carbon Disclosure Project, the Sustainability Accounting Standards Board, the investor-driven International Integrated Reporting Council, and, most broadly, the Principles for Responsible Investment sponsored by the United Nations.

Asset owners must make it clear that their primary fiduciary duty is to use professional investing skill to deliver strong returns for beneficiaries over the long term, rather than to compete in horse races judged on short-term performance.

With those metrics in hand, investors need to act. After all, for several years, data sources including Bloomberg and MSCI have been offering at least some long-term metrics—employee turnover and greenhouse-gas intensity of earnings, for example—and uptake has been limited. To translate data into action, portfolio managers must insist that their own analysts get a better grasp on long-term metrics and that their asset managers, both internal and external, integrate them into their investment philosophy and their valuation models.

Structure institutional governance to support a long-term approach

If asset owners are to do a better job of investing for the long term, they need to run their organizations in a way that supports and reinforces this. They must make it clear to themselves and others that their primary fiduciary duty is to use professional investing skill to deliver strong returns for beneficiaries over the long term, rather than to compete in horse races judged on short-term performance.

Executing that duty starts with setting high standards for the asset owner's board. The board must be independent and professional, with relevant governance expertise and a demonstrated commitment to a long-term investment philosophy. Board members need to have the competencies and time to be knowledgeable and engaged. For example, the New Zealand Superannuation Fund is overseen by a board of "guardians" selected for their experience, training, and expertise in the management of financial investments. The board operates at arm's length from the government and is limited to investing on what it calls "a prudent, commercial basis." The board is subject to a regular independent review of its performance. It publishes its progress in responding to the recommendations it receives. Two other exemplary models are the global charitable foundation Wellcome Trust and Yale University's endowment fund; each delegates strategic investment implementation to a committee of experienced professionals.

Professional oversight needs to be complemented by policies and mechanisms that reduce short-term pressures and promote long-term countercyclical performance. These could include automatic rebalancing systems to enforce the selling of equities during unsustainable booms, liquidity requirements to ensure there is cash available to take advantage of times of market distress, and an end to currency hedging to reduce the volatility of short-term performance. Such policies need to be agreed to in advance of market instability, because even the best-governed institutions may feel the heat during such periods.

A case in point is Norges Bank Investment Management (NBIM), which manages more than $800 billion in Norway's global government pension fund. In 2007, the Ministry of Finance and NBIM set a long-term goal to raise the equity content of the fund from 40 to 60 percent. That goal was immediately tested: when the financial crisis hit, NBIM lost over 40 percent of the value of its global equity portfolio, and it faced significant external pressure not to buy back into the falling market. Its strong governance, however, coupled with ample liquidity, allowed it to continue on its long-term path. In 2008, it allocated all $61 billion of its inflows, or 15 percent of the fund's value, to buying equities, and it made an equity return of 34 percent in the following year, outperforming the market. In the market decline of mid-2011, NBIM kept to its countercyclical strategy; by buying during the slide, it turned an equity loss of nearly 9 percent that year into an 18 percent return in 2012.

A final imperative for the boards and leadership of asset owners is to recognize the major benefits of scale. Larger pools of capital—more than $50 billion—create more opportunities to invest for the long term by opening up illiquid asset classes, making it cost effective to invest directly, and making it easier to build in-house engagement and active-ownership capabilities.

• • •

The right place to start moving beyond the short-term mind-sets that still dominate today is with the people who provide the essential fuel for capitalism—the world's major asset owners. It is in their own interest and the interest of savers and society at large. By making change in the way we have described, large asset owners can be a powerful force for instituting the kind of balanced, long-term capitalism that ultimately benefits everyone.

Dominic Barton (Dominic_Barton@McKinsey.com) is the global managing director of McKinsey & Company, and **Mark Wiseman** is the president and CEO of the Canada Pension Plan Investment Board. The authors lead an initiative, Focusing Capital on the Long Term (fclt.org), to move these ideas into action. This article is adapted from “Focusing capital on the long term,” *Harvard Business Review*, January–February 2014, and is reprinted here by permission.

Research in brief

Keith Negley

68
Uncovering hidden investment opportunities in Africa

Alastair Green, Conor Kehoe, and Farid Sedjelmaci

70
Private-equity operations: Inside the black box

Andrew Mullin and Alex Panas

Uncovering hidden investment opportunities in Africa

Recent research on the African private-equity market reveals a mismatch between supply and demand for financing that could point to investment opportunities.

Alastair Green, Conor Kehoe, and Farid Sedjelmaci

Private equity is set to grow rapidly across Africa. Continent-wide demand for capital should increase by 8 percent a year between now and 2018. Annual growth could reach 20 percent in resource-rich Angola and nine other countries, and $50 billion in total investment is possible over the next decade.[1]

But there will be wide variations by country and industry, and the supply of capital doesn't seem to match the growing demand. Large international investors often prefer proven investment managers, sizable investments, and diversification across Africa. Those preferences may lead them to overlook some attractive—and growing—country and sector gems.

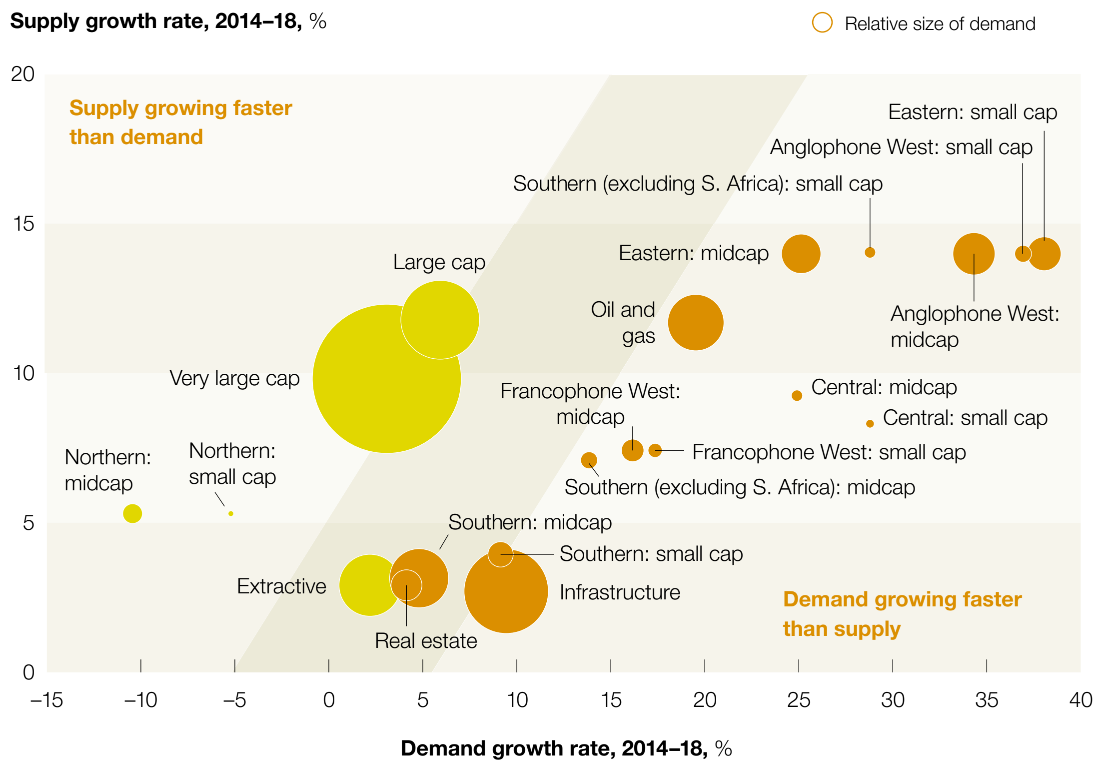
The exhibit shows the mismatch between supply and demand by investment type. On the right are segments with rapidly growing opportunities but relatively little money chasing them. These include infrastructure funds (which some investors view as too risky and politically fraught) and small- and midcap funds in East, West, and Southern Africa (excluding South Africa, which will remain a magnet for funding). On the other end are funds that will probably raise more money but face greater competition to complete attractive deals, often involving larger target companies. Multinationals seeking viable acquisition targets might look outside the active markets to midsize African companies.

[1] Estimate based on interviews with 70 leaders in the African private-equity market and an analysis of proprietary data.

Exhibit

Tracking projected supply and demand in African private equity reveals rapidly growing but underfinanced opportunities.

Distribution of African private equity, based on projected demand and supply growth rates



Source: Preqin; Standard & Poor's Capital IQ; Zawya; McKinsey analysis

The authors wish to thank Mayamiko Kachingwe for his contributions to this article.

Alastair Green (Alastair_Green@McKinsey.com) is an associate principal in McKinsey's Washington, DC, office; **Conor Kehoe** (Conor_Kehoe@McKinsey.com) is a director in the London office; and **Farid Sedjelmaci** (Farid_Sedjelmaci@McKinsey.com) is a principal in the Geneva office.

Private-equity operations: Inside the black box

Initiatives to accelerate growth are a priority; cost cutting is seen as a commodity skill.

Andrew Mullin and Alex Panas

As private equity's focus has shifted in recent years from financial engineering to extracting value from operations, a gap has opened in the public understanding of how private firms operate their companies.[1] Many firms have established operating groups, but little is known about exactly how these groups function and how they add value to the operations. Accordingly, in late 2013, we surveyed 30 private-equity firms on three topics[2]:

- the size and composition of the operating group (the number of people, types of roles, and prior experience of team members)
- the scope and mandate of the group (for example, how many companies they interact with, at what stages of the deal cycle, and on what functional topics)
- the group's governance and practices (for instance, its roles in diligence, career progression, participation in investment committees, and compensation)

The survey shed some light on how these firms are managing their portfolios. One finding was that they are placing a strong focus on building revenues (exhibit). Today, operating partners at the firms we surveyed are pursuing initiatives in the service of three goals: to boost sales-force effectiveness, improve pricing, and implement "design to value" principles (whereby products and services are redesigned to enhance margin through either higher prices or lower product costs). In conjunction with these programs, firms we surveyed are also putting an emphasis on capability building; sales and pricing skills may not be as entrenched at their portfolio companies as firms would like. Cost reduction, which in the eyes of many is becoming a commodity skill, is less of a focus.

Three other findings also stood out.

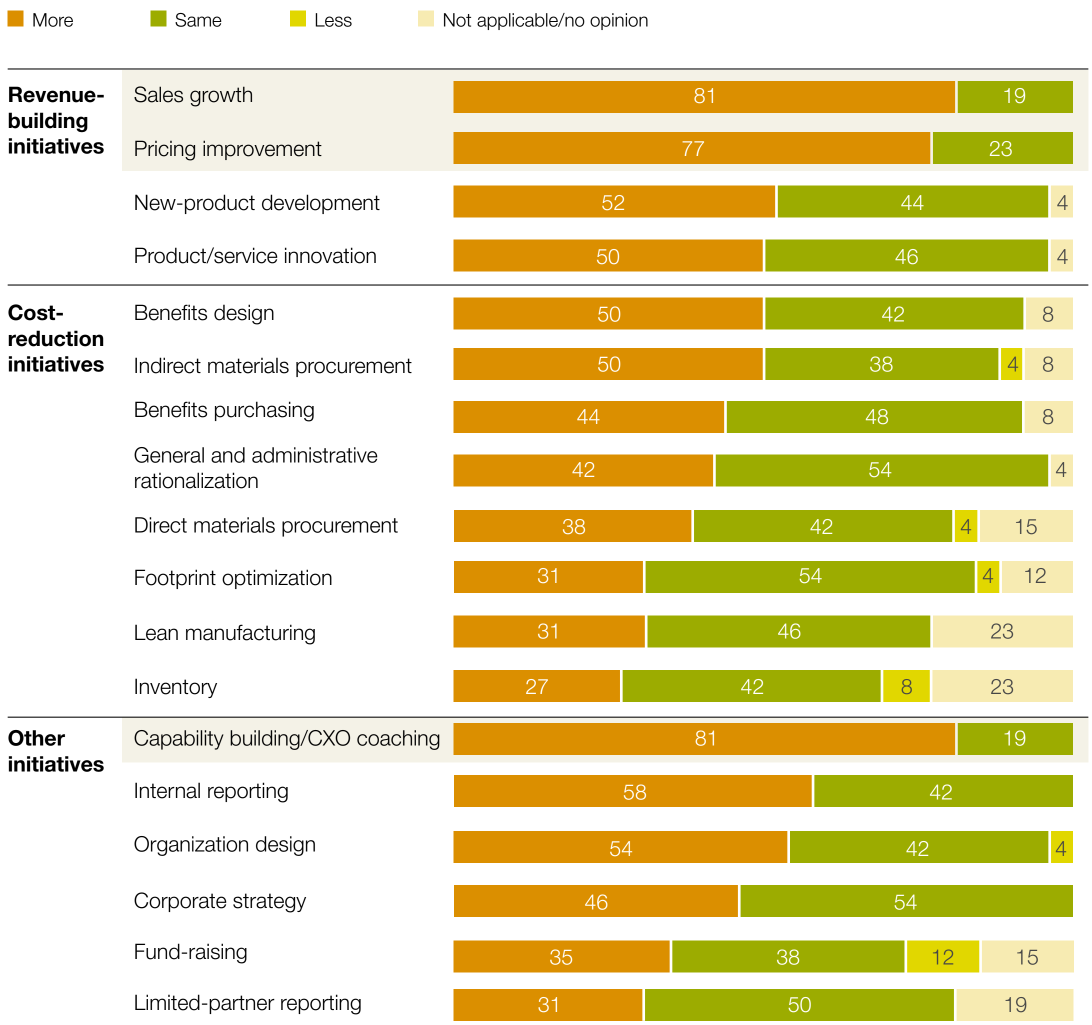
The size of the operating group does not matter.

Although the sample is not sufficient for statistical analysis, there appears to be no connection

Exhibit

Firms plan to pursue revenue-related initiatives and capability building.

Anticipated company effort over next 2–3 years, by initiative, % of respondents[1]



[1]The survey was in the field from Aug to Nov 2013 and included respondents from 30 private-equity firms. For most questions, 25 or 26 firms provided responses. Figures may not sum to 100%, because of rounding.

Source: McKinsey analysis

between the size of the firm and that of its operating group. In both small and large firms, it is most common for the operating group to include three or four people.

A 'set it and forget it' operating model is common.

At the firms we surveyed, managers spend a lot of time with their investments early in the process of acquiring them and assuming ownership. After the first 100 days, most of them fall back to monthly communications. One factor here might be resources. Operating groups tend to take on a broad range of responsibilities; we counted 25 discrete activities at one firm, and most have at least a dozen tasks. With a small team trying to accomplish a lot across many companies, the frequency and depth of interactions with any one of them is probably limited.

A standardized playbook is still elusive for some.

While some surveyed firms have managed to develop a standardized approach to most core processes across their portfolio companies, many others say they want to find ways to standardize even further. Most reported that their operating groups continue to rely on custom programs and metrics for each of the companies in their portfolio.

[1] McKinsey first visited this topic nearly a decade ago; see Joachim Heel and Conor Kehoe, "Why some private equity firms do better than others," *McKinsey Quarterly*, February 2005, mckinsey.com. In *Corporate Governance and Value Creation: Evidence from Private Equity*, 2008, stern.nyu.edu, Kehoe and coauthors found that general partners with an operational background generate significantly higher outperformance than those with other backgrounds, at least in certain deal types. For another perspective, see Coralie Hemptinne and Veronique Hoflack, *The value of in-house operations teams in private equity firms*, INSEAD, 2009, insead.edu.

[2] The survey was in the field from August 2013 to November 2013. Participating firms ranged from those with less than $1 billion under management to those with more than $70 billion and are based in all major regions of the world.

Andrew Mullin (Andrew_Mullin@McKinsey.com) is a principal in McKinsey's Toronto office, and **Alex Panas** (Alex_Panas@McKinsey.com) is a director in the Boston office.

December 2014
Designed by Global Editorial Services

McKinsey Practice Publications meet the Forest Stewardship Council™ (FSC®) chain-of-custody standards. The paper used in this publication is certified as being produced in an environmentally responsible, socially beneficial, and economically viable way.

Printed in the United States of America.

FSC logo here