Roger Urwin, global head of investment content at Willis Towers Watson and advisory director at MSCI, recently sat down with Antti Ilmanen and Rodney N. Sullivan of AQR to discuss contemporary challenges and best practices in investing. This is the sixth in a series of “Words From the Wise” interviews to be published on AQR.com. Following is an executive summary and the full interview with Mr. Urwin.

Roger Urwin, widely recognized to be among the world’s foremost investment consultants, has served as the global head of investment content at Watson Wyatt (now Willis Towers Watson) since July 2008, following over 18 years as the global head of Watson Wyatt’s investment practice from 1989 to 2008, a period that took its size from one person to over 600. His work includes consulting with some of the most important asset owners in the United Kingdom and internationally. Roger has also been involved with the firm’s thought leadership group known as the Thinking Ahead Group since its inception in 2001.

He is the author of numerous papers on asset allocation policy, manager selection and governance and sustainability. He is an advisory director to MSCI, Inc., a council member of the CFA Institute Future of Finance and serves as its strategic director and a former member of CFA Institute Board of Governors.

Roger qualified as a fellow of the Institute of Actuaries in 1983 and as a fellow of the CFA Society of the UK in 2014. He has a degree in mathematics and a master’s in applied statistics from Oxford University.
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**Roger Urwin**  
Global Head of Investment Content, Willis Towers Watson

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Executive Summary

During his career, Roger Urwin has witnessed much change in the investment industry. We begin with a discussion of two of the most important and seemingly irreversible trends — increased specialization and complexity — and their impact on the profession and on addressing the investment challenge. During his career, Roger’s successes include three global firsts: the origination of the first target date defined contribution (DC) funds (in 1988), the risk budget framework (in 1999), and the governance budget framework for assessing asset owner organizational effectiveness (in 2007). We discuss how these, among other developments, have affected the industry in support of long-term results for investors. We then gain from Roger’s deep involvement in the industry in discussing the past, present and future of defined benefit (DB) and DC plans — where we are now and where can we go from here to help better ensure a more secure and affordable retirement for investors?

We differentiate between the two types of specialized beta (often referred to as ‘smart beta’) that Roger identifies in his work: systematic, which he refers to as “better beta,” such as value and momentum, and thematic which focuses on areas of under-discovered investment such as sustainable investing. We dig into how each type can play a valuable role in investor portfolios. We explore how risk management too has seen important changes as our industry has dug more deeply into what matters in risk and better measures for it. We conclude by learning about Roger’s heroes and his career path that has taken him on a journey from the buy side to consulting, which all combine to make him a key industry advisor to so many.
Addressing the Investment Challenge

INVESTING BEST PRACTICES

CHANGE AND INNOVATION

Ilmanen: What are the important innovations that you believe have been helpful over the years?

Urwin: There have been increases in two dimensions of the investment challenge; one is specialization which has increased across the board. The other is complexity, which is, to some extent, a consequence of specialization. Both characteristics are just symptoms of our time, part of a secular trend that can’t be turned around, as I see it. I believe they have made the investment challenge in many areas more difficult than ever. But to their credit they have spawned some important innovations. The really important ones in recent times I’d say are indexation, target date funds, liability-driven investing and smart betas.

In undertaking specialization with its inherent competitive advantage, the investment industry has, I think, created a rod for its own back, because the complexity has been so intense. It has made the holistic management of our financial institutions more challenging. Even with the improvements that I see in process, organizational effectiveness, and in investment tools, I still see that accomplishing the mission financial institutions have set for themselves has not become easier; it has become harder. It seems we’ve been running faster than ever, as in the Red Queen’s Race, to simply stay still.

Ilmanen: Can you discuss good and bad practices that you’ve observed?

Urwin: One of the interesting points about industry structure in investing is that historically we’ve had relatively weak investment governance among the asset owners of the world. The biggest and best asset owners in the world are still struggling to come to terms with being effective in their investment process and practices. The good news is that the different institutions I’ve dealt with have been raising their game with respect to investment governance although many would say it’s overdue.

The good practices that I see are usually associated with getting a better balance between internal resources and external delegations. The world-class asset owners of 20 years ago were largely run through external delegation to outside firms. Now, although, we’re seeing much stronger capabilities among the biggest asset owners, challenges still exist with how they manage the mix of internal and external management.

So, the association between good practice and success is not easy to pin down. This is one of the paradoxes in the investment arena. We have so much data, but the secret sauce is no clearer. That has led me over time to think that the secret sauce is, “There can be no single secret sauce.” Investment success is really about the coming together of prolonged endeavor, effective culture and cutting-edge thinking, and the emergence of results over extended periods. This means that success is much more observable in the quality of processes rather than seeing this year’s results.

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1 We thank Jennifer LaForce and April Frieda for useful comments and suggestions, and Jennifer Buck and Pete Amis for their production support.

2 From Lewis Carroll’s Through the Looking Glass, and What Alice Found There (1871).
Sullivan: So one key aspect of success is about balancing internal resources against external delegation. A failure might therefore be in an investment organization not having enough resources to accomplish their specific strategy?

Urwin: The choice that asset owners often face is deciding whether to raise their game or simplify their strategy. In raising their game, resources have to be adequate for the complexity of the challenge, and they have to be competitively positioned as they are competing for the sorts of return that they require to be successful.

On the other hand, simplifying your strategy is another formula for success. To borrow from Charley Ellis (1975), it’s making sure that you don’t lose “the loser’s game.” Interestingly, however, relatively few funds feel good about taking this idea to the extreme — that is taking a purely passive approach. Nonetheless it remains an approach to be successful, albeit without the ambition that most of us carry.

Sullivan: How do you advise firms in making the choice between raising their game versus simplifying?

Urwin: To state the obvious, it’s a very big ask to be successful in scale at delivering alpha. On the other hand, there are opportunities to be strategically well positioned in some betas which few funds currently exploit. Funds including large ones can vary their inter-temporal exposures to beta risk with respect to the economic regimes experienced across market environments, something like dynamic asset allocation by another name. Both extracting alpha and dynamic beta present a challenge, but I’m struck by how many big asset owners have the odds stacked against them in the strategies they choose to pursue.

For me, a lot of consulting is oriented towards what I call change practices. The accepted practices of our time have been largely the continuation of certain ways of doing things, which seem almost more like folklore than the outcomes of scientific study. It’s not easy for asset owners to decide how to organize themselves. But it makes sense for them to be more realistically grounded in what they can achieve and how best to allocate their scarce resources.

Ilmanen: You mentioned changing one’s risk and beta stance depending on the environment. By this, do you mean market timing? Reminds me of the old saying, “there are no old market timers,” meaning it’s hard to be consistently successful with market timing.

Urwin: It’s quite difficult to be dogmatic about what works and what doesn’t work, because there’s so much context to these issues. But I would tend to argue that frequent interventions in allocation — often referred to as market timing — are very much an odds-against practice. That is, the odds seem quite poor to succeed with market timing and the key reason for this is that you have too few marginal calls to make — this is invoking the fundamental law of active management.

However making time-varying risk exposures by virtue of the current investment regime and your appetite for risk carries many more advantages because you are working with calls that are no longer marginal. They are compellingly attractive. The investment thesis bears upon the changing maturity profile and life cycle of different investors, organizations and macro conditions. So, applying time-varying risk budgets seem to me to be a worthwhile activity with odds-on success.

Sullivan: Can you give an example of your time-varying risk budget idea?

Urwin: A simple version of this is the life cycle design used often in DC plans, and one I worked to develop in the mid 1980s. Investment theory demonstrates very clearly that the most efficient return per unit of risk, all else being equal, emanates from equal risk budget amounts over time. This leads to the fairly simple kind of
configuration that investing in the growth phase of DC needs to be very risk-oriented, and then there needs to be some reduction in risk profile as an individual goes into their income decumulation phase.

The equivalent in DB plans is for funds that stop accruing their liabilities. They have the same sort of challenge to vary their risk budgets according to those circumstances. If they don’t, they are in serious trouble, because the problems of underfunding in mature situations can create snow-balling issues. The problems of compounding wealth under drawdown situations can be really terminal. It obviously eats into a fund much more severely when a pension plan is frozen and in an outgo phase.

Now, that’s actually just simple investment math. If you layer on top of it the concept that we do have regimes where the return to risky assets is set at higher levels or lower levels. These regimes might be five years; they might be 10 years — though I tend to think that they’re more likely to be 10 years — but therefore, this layering of “there are good and bad times in an institutional history to allocate to risk, depending on conditions,” creates opportunities. This is really about using the principles of internal rate of return (IRR) that apply money-weighted opportunities, as opposed to the time-weighted principles that we typically present in our investment materials.

At the moment, I believe we have a problem of many institutions thinking that they have to take more risk to get to the CPI-plus-five percent that makes their world better balanced. But in many respects, they should have had more risk when markets were supportive of CPI-plus-five and even higher. The high level of risk taking funds are lured into now is a bit like closing the stable gate after the horse has already bolted.

Sullivan: So, you’re suggesting risk budgeting and risk allocation as driven by the life cycle of the individual or the plan, rather than as a function of the market cycle?

Urwin: Well I’m arguing for both. Mostly, I’ve been describing life-cycle-driven allocation according to the investment context. But, I am also saying that layered on top of that is a regime consideration. Short-term market timing is more associated with the term “market timing,” but investors should look for opportunities to exploit, for example, a decade regime, or a secular regime as well.

It’s an interesting challenge at present, whether to use modest leverage to amplify returns when you have really skinny risk premia. No single answer there, but the specific answer relates to risk tolerance preferences tied to longer-term mission considerations using life-cycle thinking and money-weighted returns.

GOVERNANCE

Ilmanen: Earlier when you discussed governance, you mentioned the balance between internal and external resources. How should the board balance micromanagement of investments versus focusing on overall strategy and governance?

Urwin: A lot of my early work in the investment profession was technical, based on classically schooled investing. But gradually, I felt that I was missing so much of the action by not working harder on how individuals and organizations actually make their decisions. This was when the term “investment governance” became more and more common.

Investment decision-making is almost always a collective decision. It reflects both the board of an institution — or investment committee — and the executives who work at that institution and the delegated agents of that institution. Each of those groups comes together, and decisions are made. What has been so striking to me in my consulting life was that early on we’d spent so much time working on assessing “the great investment managers” of the time, and we neglected “the great investment committees” of the time. Early in this journey I found that a Google search on “great investment managers” generated literally millions of hits, but “great investment committee” yielded a null set. Fascinating.

Sullivan: You’ve done a lot to fill that gap in the literature over the years.
Urwin: From this observation, working with my academic partner — Gordon Clark of Oxford University — we created a global best-practice governance model. It encompasses a large number of factors, most of which are soft factors that are tacit and quite subjective. We didn’t find our factors were as simple as “investment committees should be between 5 and 7 members” (by-the-way good idea in some contexts). Instead we found that an investment organization having a ‘learning and adaptive culture that constantly challenges conventional thinking’ was a factor in success.

The Clark and Urwin (2007) governance model still is intrinsically the same structure with 12 critical factors. It produces a credit rating, just that here the “impairment of credit” is more like an assessment of possible “impairment to mission.” If you get a AAA rating, your mission is relatively secure, but if you are sub investment grade your mission is at risk.

Investment committee practice has evolved from some very casual approaches when I first started in the industry, to now more discipline and reliance on investment expertise. The best-practices model of today is unrecognizable from when I started.

Speaking both from an asset owner point of view and from the point of view of how asset managers do their work in investment committees, there are still a number of limitations in how investment committees add value. The reason is that we haven’t yet come to understand well the dynamics of groups and how to distill individual perspectives into a collective decision. These are quite subtle situations.

So, for both the asset-owner investment committees and asset-management investment committees, there’s much work to do to better understand the concepts of collective decision-making.

Ilmanen: So, avoid the “madness of crowds?”

Urwin: Good point. To get the “wisdom of crowds” you create conditions for independent ideas to come together. But when we meet as a group, our ideas become more correlated through the principles of group think and social affirmation — basically all of the issues that a lack of diversity brings. We get at best the groupthink of crowds and at worst the madness of crowds.

The specific context of investment decisions makes this a lot more toxic. To borrow a phrase out of American military, we invest under conditions of volatile, uncertain, complex and ambiguous conditions, or VUCA. To be effective in making decisions, our thinking processes must deal with all those VUCA dimensions.

Because so many investment settings are uncertain and ambiguous, the process of settling the views of many investment professionals is highly problematic. But the more you do think about that, I think the more you recognize that the typical way that we run our meetings does not lead to the state of good diversity in thinking. There is a yet-to-be found formula — a more definitive theory and practice of investment committee decision making.

Ilmanen: Other thoughts on best practices for plan sponsors?

Urwin: The upskilling of plan sponsors and other asset owners is an encouraging sign that we may do better in the next financial crisis. We have lived through an era of “asset rich - time poor.” Now we have a more effective picture with much more skilled asset owner CIO’s.
A good example is the work being done in investment beliefs. Asset owners have been increasing attention to the areas of their investment beliefs such as investment philosophy and value system. Best practice has always involved connecting the dots among many funds, and some are now doing this quite well.

I find an interesting difference between the way that asset owners/plan sponsors have evolved and how asset managers have evolved. For investment managers, though also schooled in investment philosophies, beliefs and values, it hasn’t seemed as productive to deepen their thinking this way. I can only ascribe that to some of the consequences of the secular push towards specialization of mandates. So the type of thinking that is needed in forming investment beliefs is essentially done for the manager in the specification of the mandate.

I’m mildly troubled by that outcome because I would like to see the asset management industry have a more multi-asset, full-service reach that deepens their thinking in establishing a value system. This directional push towards specialization has made things a bit difficult for most asset management organizations. The breadth of an organization like AQR is quite unusual.

**PENSION PLAN FUNDING**

**DEFINED BENEFIT PLANS**

**Sullivan:** Let’s now turn to another challenging topic, pension plan funding.

**Urwin:** Overall, in most parts of the world pension fund balance sheets are obviously stressed. Because pensions are future assets and liabilities with ongoing sponsor support you don’t need to immediately balance the balance sheet. But we have a chronic bad habit with dealing with underfunding by kicking the can down the road. And the specter of a slow-motion pension train wreck has come to haunt me.

**Ilmanen:** Would you advocate plans bite the bullet here and immunize despite low bond yields or continue to use risky assets to try to climb out of the underfunding?

**Urwin:** The flippant answer is yes and yes. Combining DB and DC plans, there are about $40 trillion of total pension assets worldwide with about half of that in DB plans (Willis Towers Watson (2016)). Liability-driven investing (LDI) is best seen as hedging, not matching. Some funds have been adapting to liability management through derivative positions. This has already helped some funds in adapting to the current low bond yields. However, the bond market can absorb even more pension hedging while accepting there are limits.

I tend to think doing more hedging makes sense. But I also think it is possible, and likely desirable, for many funds to run a partially-hedged position with the help of derivatives and also have a portion of the assets continuing to take risk. But it’s a really tough set of issues. As soon as you get into the details, there are so many factors involved.

**Ilmanen:** How would your advice differ for public plans versus corporate plans?

**Urwin:** Well, the public funds in the U.S. are altogether not in a good place. In some respects, the key to outcomes is actually the flexibility of ‘pension property rights’. This is whether pensions once promised are fully secure over time. Pension property rights have been very strong in most places in the world, though not everywhere.

It is all rather different when we’ve been overpromising for some time, and our whole system of negotiation and agreement of pensions has been a social failure. These are intergenerational promises which were, I think, either unrealistic or too aspirational. So, how flexibly can public funds deal with their multiple stakeholders, taxpayers and beneficiaries and can or should it involve changing the benefits? My generation has done extremely
well out of these pension systems, but the future generation of my kids is not in such good shape. Some group is going to have to give up something.

Now, again, these are intergenerational and equality questions. I find it interesting how investment professionals are again right at the center of something that is so important to society. I feel a sense of responsibility about being part of a profession that should be working hard to provide some kind of improved method of securing intergenerational equity. That’s really the heart of the financial system.

Ilmanen: The Dutch, who seem to be among the countries with the best pension finances, are nonetheless among the least happy people on this topic, perhaps because there is a greater awareness about pension-related challenges.

Urwin: We’ve created institutions that are very difficult to manage and ambiguous in terms of how good they are. It’s just not totally clear if we’ve got the best pension system or the worst pension system in any country. These are very long-term settlements; they involve multiple generations being added together. It’s interesting that the Dutch, who have done better with DB than most countries, now feel drawn to collective DC.

Ilmanen: Why do you think investors in Anglo-American countries tend have much more in equities than those in say Japan and Continental Europe?

Urwin: I think there are multiple reasons for such differences. Some of them are captured by national culture, others are captured by what I might term serendipity of past practice — for instance, the consequences of multiple, and often ill-advised, changes to the respective pension systems. Out of such histories these differences arise.

As we know, if a solution to a problem is ambiguous, such as what’s the best asset allocation, then you’re more likely to go with accepted local practice — what’s been done in the past.

Ilmanen: If you are not thinking too much of the next generation, then you are happier to roll the dice and hope for the best?

Urwin: There is a really neat paper on intergenerational equity recently published in the FAJ that, as you suggest, discusses the existence of a generational temptation to roll the dice (Bader (2015)). There are very clear incentives that make that a desirable feature. However, it’s important to find a way to give voice to the future generation stakeholder. Consider how, in the past, some used pensions as a negotiating tool rather than focus on pay, which tends to be less flexible.

Sullivan: Where did the use of pensions in this way begin?

Urwin: There are examples stretching back, but a good one is from Australia where the Australian Superannuation Guarantee, originally a three-percent employer contribution, was paid into a DC account instead of a pay rise beginning in the early 1990s. And so as a result of an old bargain, you’ve had 25-plus years of the growth of a DC system. South Africa is very similar.

**DEFINED CONTRIBUTION PLANS**

Sullivan: Do you think this change from DB to DC was desirable?

Urwin: I have a somewhat pragmatic point of view, that it was inevitable that we would never be able to secure the intergenerational equity needed to make DB a fair deal for all parties. The reason really is that the risk sharing of the employer and the members of the defined benefit fund is almost impossible to describe. It’s too reliant on the social capital between employers and workers that has over time been weakening. So, employers found their way out of the overcommitted undertakings of DB and moved on to DC with the dual benefits of fixed and lower costs.
The most undesirable part of this transition was that there was never an architecture, culture or governance put into place to take on the mantle of the DC system to make it effective. As a result, we have this rather clunky system of fragmented accounts which don't operate well together as a grand design.

I'm a big believer that DC will take on better design features in the future, but for a number of governance reasons, it has been a very slow-moving machine.

**Ilmanen:** Resulting perhaps in an unlucky generation of investors.

**Urwin:** Unfortunately yes, DC, as it currently works, is not a pension income system. It’s more of a clunky savings system with low contributions. Where defined benefit was 15% to 20% of payroll, DC has been around five-percent to 10% savings. So, it’s no surprise that the expected benefits are more than halved.

**Sullivan:** Compounding this issue is the expected low return environment. It takes almost twice the savings rate to make up for a two-percent lower return over one’s career (Ilmanen, Rauseo and Truax (2016)).

**Urwin:** Yes, sadly, DC is poised to under deliver, due to both the low level of contributions and likely lower future returns.

**Sullivan:** What are some better design features that could help close the gap?

**Urwin:** At the moment, DC design is weak and institutions are not taking responsibility for any consolidation of pension savings, pre- and post-retirement. Take a 401(k) plan in the U.S. It acts as an accumulation vehicle through to a target date, but the design doesn't lead to a particularly effective hand-off into a post-retirement income benefit guarantee. And there is no overall consolidation as the individual will often accumulate three or four defined contribution pots.

A better system requires a design which allows accumulation and decumulation without interruption and on a consolidated basis, as opposed to the multi-employer, fragmented basis that we see today. It would be good to see more profit-for-member institutions equivalent to Australian Super funds and NEST in the U.K., among a few others.

**Sullivan:** So there are some models to build upon?

**Urwin:** Yes, there is a big opportunity to build a coherent investment design based on the life-cycle principle. The other aspect of effective design is that you need to allow for the limited engagement of plan participants. So, things like auto enrollment and other behavioral-based initiatives can help to overcome the problems related to financial literacy and inertia. It’s really about overcoming the quirks of individuals for success with our retirement outcomes; in a word “nudging” them. But, I am quite positive about people taking more responsibility for their pension income, and I’m certainly not of the view that the majority of people should be destined to buy a low-yielding annuity at retirement.

**Ilmanen:** What about the role of target date funds?

**Urwin:** The target-date fund design is a version of life cycle design based on the limited data of savers saying, “I might expect to retire at a certain age.” It makes sense but it hasn't in practice materialized as well as you might imagine because it’s such a crude default. There's only so much you can do with default funds designed for a mass market. Default funds are very crude, because they represent an average type of person, and there is no average person out there, really.
ALTERNATIVES

Ilmanen: Let’s turn to discuss the role of alternatives in a portfolio, including both illiquid and liquid types.

Urwin: I always start my thinking off with what I call the “world market portfolio of investables,” which has about $90 trillion of liquid assets — stocks, bonds and commodities — and about $10 trillion of alternatives — roughly $6 trillion of real estate, $3 trillion of private equity and $1 trillion of infrastructure (Doeswijk, Lam, Swinkel (2014)).

So, illiquid alternatives represent about a tenth of the marketplace. While there is an opportunity to be skillful there, it’s a pretty tricky space. If alpha is difficult, I tend to view alternatives as being particularly challenging. There’s a dimension about choosing your providers, including your internal teams and then there’s the dimension of several layers of costs, and we tend to under estimate that. We don’t keep score well enough to recognize what an impediment the costs are to achieving ultimate success.

SYSTEMATIC VS THEMATIC BETA

Sullivan: You have been part of the smart beta movement from the beginning; tell us how that came about.

Urwin: At Watson Wyatt, we had a research team called the Thinking Ahead Group (TAG) that wrote about risk-weighted, fundamental-weighted, and value-weighted investing in 2002 and 2003 using the term “beta prime” to capture the premia we were finding. So, we were enthusiastic protagonists for those systematic factor approaches around that time although clients didn’t particularly like it. It was very similar to the passage of index funds in the 1970s. So as a result, and much to my surprise really, the idea went quiet, but then it came back after the Global Financial Crisis, and it was then we tried using the term “smart beta” (Watson Wyatt (2007)).

Smart beta then became defined at Towers Watson as a vehicle for methods that combined mechanistic rules-based, simple governance, low cost, with a projectable economic rationale, and a return driver that compensates for the risk taken.

Evolution of Smart Beta

Source: Towers Watson
Sullivan: You have also differentiated between systematic and thematic beta; can you explain?

Urwin: To me systematic beta is a technical capture of “better beta.” Gene Fama describes it well when he says that the value premium is about different prices for different volatilities. I like to describe it as “different prices for different risks to different investors.” So value turns out to be exposure to bad-time risk which provides the return driver for the valuation premium.

Ilmanen: We employ four systematic betas: value, momentum, carry and defensive (which combines quality and low risk).

Urwin: Yes, we are consistent with that in our thinking. Each of those has a projectable economic rationale. So, while there can be behavioral mispricing (a pricing anomaly), to me the principal return driver for most of these is different risks and the heterogeneous views that price them.

Ilmanen: Makes sense. Do you explain momentum, though, mainly with behavior?

Urwin: Yes, I would.

Ilmanen: Some include different weighting schemes, like equal-weighted or maximum-diversification, as part of smart beta.

Urwin: Risk-weighted is actually the equivalent of the thinking in risk parity. It’s about the degree of efficient return per unit risk

Ilmanen: Yes. Let’s get back to your distinction between systematic smart beta and thematic smart beta.

Urwin: Yes. The thematic version of beta says that certain areas of investment will remain under-discovered and by implication, underpriced. So, in thematic beta, the proposition is more behavioral related.

Sullivan: Can you give an example?

Urwin: Sustainability. It is based on the concept that most invest with a low regard for externalities. So, thematic beta is about a kind of first-mover advantage; it is not permanent, it doesn’t last forever. Consider, for example, how low carbon is exposed to low externalities and could earn a premium over time as carbon becomes internalized and therefore gets to be properly priced.

Sullivan: How do you evaluate thematic opportunities?

Urwin: In dealing with sustainability thematic beliefs, there is a lot of debate.

Systematic beta is focused on risk premia with an empirically solid foundation, which is a more top-down inductive approach. Whereas a thematic type of investment requires a beliefs-based, bottom-up approach, which is more based on deductive thinking. So, justifying sustainability to me warrants more of a deductive approach, not just based on track records. But the investment world is thoroughly schooled in needing its inductive fixes. So, for a low-carbon approach to be considered we would first need proof in the performance.

Now, if you believe, as I do, that the financial system is a complex system that is never quite in equilibrium, then any historical projection carries the problem of the intermediate pricing point — that it can be high or low. So, projecting an alpha from a factor is difficult. It’s almost the wrong way around based on the benefit of hindsight, the period in which you’ve done your analysis. So, it challenges some of the principles by which investment research is organized; as in, it becomes less obvious that you need to be pure in your econometric or data-driven approaches.
Ilmanen: We are in the systematic camp who study historical experience extensively, but even we want to think hard why any long-term regularity exists: Is it caused by some risk aversion or irrationality? Those who take the other side are rewarded if they are in the minority.

Urwin: Yes, that's right, they get a premium, if they survive long enough.

Ilmanen: Whereas with deductive ideas you are constantly in a position of judging between two sides of a story?

Urwin: That's absolutely right, there are two sides to every story. Sustainability is fascinating; there are two dimensions of utility vying with each other — financial utility and an extra utility which is non-financial. The non-financial utility says, “I have to take some responsibility for the footprint of the world today and in the future.” These two factors will be priced differently.

Back to the carbon example; there's first a non-financial responsibility to it, “Do I really want to have that responsibility? In 10 years’ time, I might feel bad that I was a cause of distress.” But it also has the financial dimension that says, “This carbon in an oil company is going to be priced differently in 10 years’ time, and I don't know if the market is putting the right price on it.” The organizations I advise are trying to sort all this out, but it’s a really difficult issue.

Ilmanen: How does this tie into the universal owner idea?

Urwin: I think universal owner is quite an important concept. It is really about ownership influence and making sure that the objective function of the organization is attuned to the mission of the organization, which one firstly assumes to be a wealth-maximizing utility. The universal owner assumes that they, as long-term holders, can through ownership rights influence wealth. For example, weaning companies off lobbying costs — to a universal owner lobbying is net-value destructive across their whole portfolio. But then a universal owner may well think about their objective function as not just a wealth-maximizing utility, but also a wellbeing-maximizing utility, where wellbeing may include environmental conditions. It argues for creating portfolios that are potentially lighter in externalities than the market. Of course that's a thesis, and it needs deductive logic to make it work.

Ilmanen: And you might accept a few basis points lower returns for that?

Urwin: This gets into a debating point about the mission of the organization. We have yet to come to terms with the “ethical tiebreaker” which says it's absolutely fine to commit to an ethical cause if the prospective investment return is roughly tied.

Interestingly, many funds have come to terms with being out of tobacco even though tobacco has been the number one sector over the last 100 years. For me, the last 100 years isn't a basis on which I'd build a forward-thinking case. But for some people, it would be. And that's the issue.

Ilmanen: And to really get financial rewards for market repricing on any theme, you’d have to get right the timing of when investor attitudes change.

Urwin: That’s spot on. Yes, themes may typically have a 10 or 20-year run. Oddly, as we know, institutional mechanisms don't deal well with 10-year periods. So, it's a tremendously tricky area. I am working with an initiative at CFA Institute called the Future of Finance which has tremendous potential to stretch the thinking powerfully for the benefit of beneficiaries in two dimensions. One is wealth, and the other is wellbeing.

Sullivan: A balance between finance utility and social utility.

Urwin: Yes. There is really a need for investment professionals to be societally savvy and to do the right thing. The 2015 United Nations Climate Change Conference (COP21) is hugely important to this. What's happening is that the calibration of belief systems is changing slowly. What has been evident for a while in the eyes of virtually all of the scientists is now starting to become semi-mainstream with politicians who are beginning to recognize they've got a responsibility to do the right thing for future generations.
Sullivan: Interesting that empirical research on ESG investing has shown mixed results. Some studies show ESG outperformance or roughly in line with the market, while others show underperformance.

Urwin: Yes, that’s true. My premise is that this issue will continue to show an undulation of performance, with no compelling winner and loser.

Sullivan: So, how should we think about the financial case?

Urwin: We need to do the more diligent work of unpacking investment return on an accrued cash flow basis and extracting the end pricing multiple which should not form any part of the projectable component of return. The cash flow accrued return is something that represents sustainable outperformance. It’s basically undressing the return in more sustainable terms.

Sullivan: How does the externality come into play?

Urwin: The nature of an externality is quite similar. You’re booking the benefit of the externality by not incurring the associated cost because it’s unpriced, but then one day that externality turns into an internalized cost. So, by avoiding that externality before it’s priced, you benefit in the long term. That’s the nature of externalities. That’s why the universal owner can use deductive thinking to position their portfolios to be lighter in externalities than the market and justify that position. It’s a justifiable cause.

Ilmanen: Are there other thematic investment ideas that you’d like to mention?

Urwin: There are other slow-moving but predictable opportunities such as demographics, emerging wealth, healthcare and infrastructure. Also, the GFC produced some bank-driven capital flight that produced mispricing in various types of credit investments. These areas are quite idiosyncratic and require solid governance oversight.

RISK MANAGEMENT

Ilmanen: Let’s turn to practices in risk management.

Urwin: In my career I have seen risk management become bigger and bigger. I think the perspective on what matters in risk is much better understood than it used to be. Some of the measures of what we look at to understand risk are more insightful now than what we had in the past. But I’m still struck by the pattern that we tend to measure what we can, and de-emphasize things that we don’t seem to be able to measure, even when they matter more than the things that we can measure.

For example, the key risk to a DB plan is mission impairment risk, which more often than not would emanate from something in the financing covenant configuration than in the investment policies. We calculate Value at Risk for the portfolio to two decimal places, but the key dimension lies in some different place altogether.

Ilmanen: What sort of things would cause that mission impairment?

Urwin: The key dimension to most DB mission impairment is simply the sponsor becoming insolvent. Now, obviously, if you’ve invested your funds in a correlated way with a sponsor, you’ve made that risk worse, but very few pension funds think that one through or practice an integrated approach to their risk.

Another mission impairment example might be a DC plan with insufficient contributions to produce the needed retirement income.
Ilmanen: A change in focus is needed?

Urwin: We tend to measure the exogenous risks foisted on our system from macroeconomic and market-related factors. On the other hand, an endogenous model is one where the stakeholders are part of the system and we view their behaviors as sources of risk and return at the same time. There is a spectrum from highly quantifiable like calculating historic Value at Risk, to things that are not very quantifiable, like estimating the risk of longevity for a DB plan.

Sullivan: So where do you see the practice of risk going?

Urwin: It’s a bit corny to say it should go wider, longer and deeper but that’s basically it. Wider in that the central element of investing is achieving success with a unique fund-specific mission which specifies the stakeholders and time horizons that need management. The definitions used in mainstream finance are narrow and don’t reflect much relevance really.

Then there is a need for a lengthening of the time horizon to risk. While mainstream finance risk is calculated from measures that are daily or monthly, longer-term risk is really about periods as long as decades and consistent with missions that are multi-decade in nature.

The deepening of risk is about picking up fatter tails and the non-stationary elements and also, the asymmetrical pieces. Risk done well looks at the whole return distribution.

All of the above is pretty difficult, but then if it was easy it wouldn’t be as much fun.

Ilmanen: Thank you for sharing your insights with us. It’s been a real pleasure.
Ilmanen: What drew you to investing, and what was the environment like at that time?

Urwin: In 1977, I had completed three years at Oxford on maths and one year on applied statistics and, like most folks my age, was looking around for a secure profession. I was drawn into the consulting field of pension and investment and decided to become an actuary.

I joined the company that would eventually become Aon Hewitt. Back then it was a small firm where the main work was concentrating on the performance measurement of U.K. pension funds. This was the early days and performance measurement was all about using time-weighted returns to make comparisons and interpret the results for some very basic investment strategies; really, just domestic-listed securities, equities and bonds, and not much else. By today's standards a very bland environment. After the turbulence of the mid-1970s, markets were starting to behave again, so it was a slow-moving but steady start to my career.

I was drawn to do all the work in the investment challenges of these pension funds, and most of it was about manager selection. It was about using the available performance data to identify those organizations that seemed to be better performers and making comparisons that led to the very early beauty parades. "Beauty parade" was a term that probably had been around for a while, since Keynes, but on the other hand, it had only recently become the formulaic way for selecting managers.

So, my early work was as a fund manager, trying to select what were the choice British merchant banks at the time. The organization that seemed to be doing best with this was Warburg, which then became Mercury, which then became Merrill Lynch, which then became BlackRock. So, there you have 35 years, or so, in terms of how organizations grow and have moved on.

There were a couple of important themes that were knocking around at the time simply about being a professional, a word that I think has come from that era, but has not totally made the passage of time.

Ilmanen: By that you mean performance being the first thing that one looked at as part of the professional assessment and then going beyond that?

Urwin: Yes. Even though the now well-worn phrase, “Past performance is no guide to the future,” was used at that time, I don’t think we believed it back then. It’s taken me a long time to work out that it’s probably true.

Sullivan: What was your path to Towers Watson and how has this path shaped your thinking about investing?

Urwin: My journey took me via Mercer, which was developing its investment capabilities, to Gartmore Investment Management. I spent some very happy time in the 1980s at Gartmore. I was head of the quant approach to investing there and was also doing a lot of work in the development of their business. It was a very interesting time.

Ilmanen: So, this was investment management?

Urwin: Yes. It was my brief time in investment management, which included the design and development of the first life cycle products in defined contribution around 1987.

I then joined a company called Watson’s, probably the biggest actuarial firm at the time, as the first employee in their investment practice. It then became Watson Wyatt bringing it into the global arena, which then became Towers Watson in 2010 essentially doubling its size (and the latest merger in 2016 created Willis Towers Watson). It has been very interesting being a part of the way that these organizations have gathered pace through natural growth and consolidation over the years.

I was the global leader of the investment business for Watson Wyatt until 2008 when I decided to step away to focus more on clients. I also joined the board of CFA Institute. So, I’ve been able since 2008 to do the things that I kind of love doing, as opposed to the things that the business demands. So, flexibility in role has been a very crucial part of
Ilmanen: Tell us about the Thinking Ahead Group in Towers Watson.

Urwin: Well, thought leadership has always been important in my life. It’s obviously a slightly exaggerated term, but I see thought leadership as finding things that are arresting. They stop people in their tracks. They’re actionable. And they can be properly socialized, so that people eventually “get them” over time.

Around 2002, working with a colleague, Tim Hodgson, I decided to commit to a particular style of thought leadership which became the Thinking Ahead Group. It’s called now Thinking Ahead Institute and we are able to do more research than in the past by including, for instance, both asset owners and asset managers.

As an example of the thought leadership, we claim very early seminal work on risk budgeting. We also launched the governance budget proposition to the world, how organizations commit resources and how organizational effectiveness can be gauged as part of the investment success. The measurability of the resources and the connection between that and investment outcomes are important to success. It’s difficult to measure, but is nonetheless part of the thesis of investment governance.

There is a series of ideas that we’ve plotted over time. Usually, we have to wait five years before a good idea actually crystallizes, at least that’s our experience. Committing a significant amount of resource to something with such a slow payoff took a bit of bravery on the part of the firm. But once you’ve got a track record, you can create a pipeline of ideas and Towers Watson can claim it as part of the DNA that drives it. It’s pretty exciting.
Ilmanen: You are a hero and role model to many. Any heroes or role models that you would like to highlight?

Urwin: There are two types of role models. One of them is a bit like a mentor, and I feel pretty strongly that it’s a really important part of people’s development, but you have to strike it lucky to have this particular type of mentor. In my time, I actually have had two. One is Paul Myners, who among other things, was the chief executive at Gartmore in my time there; and the other is the former CIO at Gartmore, David Watts. It’s interesting that I’ve had more influence from my time in asset management than from my work in consulting.

Then there are heroes, more generally, in the investment industry. I was struck that you have included two of my heroes, Charley Ellis (2015) and Marty Leibowitz (2015), as part of your Words from the Wise series. They are both outstanding investment professionals whom I’ve had the pleasure of working with over the years.
References and Disclosures


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