Guest Speaker Spotlight

Ross Blakers and Nicole McMillan, Whitehelm Capital

Ross Blakers

Nicole McMillan

The SMF was pleased to welcome two members of our Investment Advisory Committee, Ross Blakers and Nicole McMillan, as guest speakers on 31 August 2020. Ross and Nicole provided an overview of asset consulting, discussed challenges in the current investment environment, and offered key takeaways from their time in the industry.

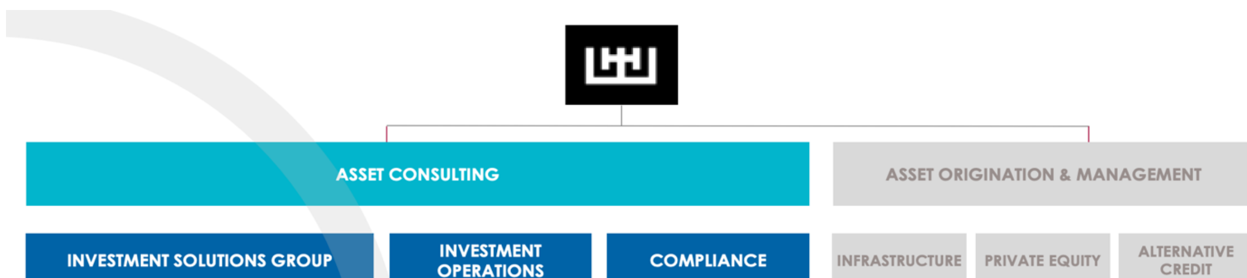
Ross Blakers is a Strategic Advisor at Whitehelm Capital and sits on the firm's Advisory Investment Committee (AIC). He assists clients and team members in asset consulting matters covering areas including investment strategy and manager selection. Nicole McMillan is a Senior Advisor in Whitehelm Capital's Investment Solutions Group, and is responsible for currency analysis and management, as well as researching current trends in global financial markets.

Below we share some of the key insights that Ross and Nicole provided, as well as summarising the Q&A session that followed.

Whitehelm Capital

Corporate Structure

Ross and Nicole gave an overview of Whitehelm's structure (see figure below), focusing on the Asset Consulting arm where they work in the Investment Solutions Group.



The Asset Consulting arm, whose clients are predominantly Australian superannuation funds, comprises of three groups. The Investment Solutions Group provides investment guidance and insights to clients, helping them to achieve their goals with efficient use of resources. The Investment Operations team assists in proposing and implementing investment recommendations subject to client needs. Meanwhile, the Compliance team verifies the feasibility of potential solutions and provides market insights.

Investment Manager Selection Process

Many clients entrust investment managers to invest on their behalf. Whitehelm assists them by undertaking a rigorous manager selection process, ultimately selecting the most appropriate manager from a large initial pool (~70) based on the client's objectives and manager's capabilities.

The first step is to understand the client's beliefs and objectives, such as specific targets for returns and tracking error. Manager screening is then undertaken to identify potentially suitable managers. In addition to the potential to deliver performance, other considerations might be management fees, ability to manage tax, or investment style, e.g. value vs. quality, large vs. small-cap, active vs. passive. The qualitative screening helps identify managers with specific styles that align with the clients' objectives. Manager capability is also examined, in part through an evaluation of past investment performance taking into account the size of investments and how their style has been performing. In this context, it is important to assess whether they are able to meet their promised target returns, given the market environment. In the case of multi-manager investing, the screening process also seeks to identify managers with sufficiently different styles and market exposures in order to reduce redundancy that can arise from too much overlap between managers.

Ross and Nicole emphasized the importance of in-depth due diligence, to mitigate behavioural biases such as manager over-confidence. This often leads managers to hold stocks for too long and unwind profitable positions too slowly, missing the perfect timing to exit. This bias has led quantitative funds to use the selling decisions of successful funds as a profitable signal to short stocks.

Governance and Decision-Making Structure

Whitehelm uses a rigorous decision-making process in preparing a recommendation for a client. Advisors first draft a paper outlining the recommendation and supporting analysis, which is then reviewed by internal peers. It is then submitted to the AIC for review and comment. If the recommendation is rejected at any stage, the team will go back to the drawing board. The final proposal presented to clients therefore undergoes multiple rounds of discussion and screening.

To enable Whitehelm to respond quickly to fast-moving financial markets, out-of-session meetings with clients' and their Investment Committees may be organised in reaction to sudden market fluctuations. The efficiency of this process depends on clients' governance processes as well, with some set up to react quickly to market fluctuations and others less suited to opportunistic short-term investment decisions.

Importance of Company Culture

Culture has tremendous importance to the long-term performance of a company, and is key to gaining the trust of clients. At Whitehelm Capital, employees are strongly encouraged to embrace company culture and values such as teamwork and integrity. Such factors form part of employee KPIs and can influence their salaries. Likewise, when evaluating potential external managers, evaluation of fund culture is critical, albeit challenging.

Ross and Nicole emphasised the importance of considering the culture of your company through the course of your career. This can be difficult to gauge at the start, and usually becomes clearer the longer one remains with a firm. If senior managers uphold the wrong fundamental values, there is a greater risk of a scandal arising from poor work culture. When evaluating potential employers, the Glassdoor website can be useful for evaluating corporate culture.

The Mantras of an Asset Consultant

Ross and Nicole shared their mantras for asset consulting, including:

- Performance can be measured by whether the client adopts the final recommendations.
- Absolute clarity on the client's investment beliefs and objectives is crucial, as these should form the basis of investment decisions. For example, while superannuation funds typically focus more on absolute performance, peer risk may still be relevant if a client cares about relative performance.
- Consultants should consider diverse dimensions of risk. They need to be critical, sceptical of market behaviour and trust their own judgement. Before making a recommendation to a client, they should try to spot potential weaknesses and aim to "break their solution", with a view to avoiding outcomes that could fail.

Considerations for Asset Allocation

The current financial market is structurally challenged, with numerous threats:

1. The interplay of extreme monetary and fiscal policies;
2. Extreme debt, valuations and inequality, with high debt levels partly due to central banks keeping interest rates low to stimulate the economy since the Global Financial Crisis;
3. Climate change is being taken more seriously, with some governments issuing green bonds;
4. Changes in the geopolitical climate, with de-globalization raising market volatility;
5. The downward shift in interest rates is having profound impacts on market movements, and is affecting asset pricing via discounted cash flow (DCF) modelling effects.

Markets hence face a number of risks. New portfolio protection tools are needed.

Q&A

1. **If investing in overseas equities, how many stocks is an appropriate number? Can an investor start with less than 10 stocks? If focusing on a particular sector like infrastructure, do you have any advice based on your experience?**

The ultimate issue is the amount of excess return and the amount of risk that you are willing to take for each asset class in the portfolio. If you want a tracking error versus the index that is lower than 150 ~ 200 basis points, this might be very hard to achieve in a concentrated 10-stock portfolio. So it's possible for an investor to start with less than 10 stocks, but they need to expect large performance variation against the benchmark. There are many countries and sectors in a global index. One option might be to limit the universe size, for example by investing in an ETF that covers MSCI World ex US, and then run the active portfolio just in US equities.

For listed infrastructure, in recent years there has been the development of some excellent indices (FTSE) that help sort out infrastructure and utility stocks from others that don't have the same underlying attributes. There are both active funds and benchmark-following ETFs that can offer good exposure. If looking at individual stocks, you need to identify their underlying drivers. For example, key contracts that underpin revenues need to be well understood, along with a good understanding of the debt profile as often these stocks have considerable debt levels (due to the reliable underlying earnings). Building DCF models and analyzing revenue streams is usually required.

2. **How do you incorporate Environmental, Social and Governance (ESG) factors at the portfolio level?**

Clients will have different ESG preferences. It is important for asset consultants to ask clients whether they have explicit ESG requirements, and incorporate these into their recommendations. For example, they might seek managers with a target reduction in carbon emissions. At the manager level, investment processes should explicitly consider ESG factors. Funds should have a clear ESG process, and the flexibility to adjust their approach based on investor preferences.

3. **How concerned should we be about very low cash rates and modern monetary policy?**

Central banks can no longer use traditional levers such as lowering interest rates to stimulate the economy, so have resorted to Quantitative Easing and large government bond purchasing programs to bump up liquidity. The Federal Reserve has indicated that they will keep interest rates at very low levels, but have also stated they are unlikely to reduce rates below zero. It will take several years to determine the limits to the size of the balance sheet, which has expanded rapidly and has taken the 'effective' federal funds rate well below zero according to some estimates. In any event, the current policy settings pose considerable risks to financial markets over the long run. The low cash rate may ultimately prove unsustainable. Another concern is whether markets are driven to levels from which they collapse after they peak. It is very difficult to say when this will occur: it might take several years. Once this point is reached, tail risk and the possibility of negative feedback effects may emerge.

Recorded by Cheryl Yang (Relationship Officer)