Navigating the complexities of investment governance – today and in the future

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Foreword

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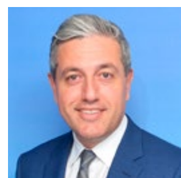

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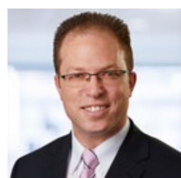

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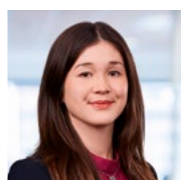

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The journey towards effective investment governance is not merely a case of arriving at a destination but is a continuous evolution. It requires foresight, adaptability and a commitment to best practice. In this article we delve into the nuances of investment governance drawing insights from a rich tapestry of experiences and perspectives.

Through the lens of Frontier Advisors' three decades of experience advising institutional investors – combined with KPMG's experience in working with clients across advisory, audit and tax – KPMG and Frontier have joined together to bring our insights and perspectives on investment governance to asset owners to aid their navigation of an increasingly complex investment governance landscape.

This thought leadership article combines Frontier and KPMG's unique strengths in local and international markets, fostering a synergistic collaboration to provide asset owners with leading industry insights that deliver value and confidence in handling investment governance challenges.

An extensive investment governance survey undertaken by Frontier for this article has provided valuable foresight into the challenges and opportunities that lie ahead for asset owners. From the implementation of robust investment governance frameworks to the pivotal role of leadership in driving excellence in investment governance, this article offers a glimpse into the intricate dynamics within asset owners both in Australia and internationally. The Frontier survey underscores the sobering reality that asset owners face negative impacts to performance for poor governance, and points to the urgency for organisations to establish a process to review and uplift investment governance practices that not only mitigate risks but also foster sustainable growth.

Whether you are a seasoned industry veteran or a newcomer to the world of investment management, you will find invaluable lessons within this article. We hope these insights motivate you to chart a course towards excellence in investment governance, mitigating risks and seizing opportunities in an ever-changing investment governance landscape. Please reach out to discuss, question or add to these findings.

Survey scope and methodology

In November 2023, Frontier Advisors conducted research into investment governance across asset owners in the Australian investment management industry. Key inputs of the survey are summarised as follows:

- Representatives from 22 different organisations completed the survey
- The total assets represented by these 22 organisations is $800 billion.

The aim of the survey was to collect information about how Australian asset owners are considering and managing investment governance currently, and how this approach is expected to evolve in the future.

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Background

In today's dynamic investment landscape, the role of investment governance cannot be overstated. As financial markets evolve, so too must the investment governance frameworks and practices which underpin them. In this article we explore the critical importance of good investment governance across institutional asset owners, drawing insights from a comprehensive investment governance survey conducted by Frontier Advisors.

The survey, conducted among institutional asset owners, revealed a consensus among respondents regarding the profound impact of investment governance practices on investment outcomes. An overwhelming 68% of surveyed participants emphasised that asset owners with poor investment governance practices faced disproportionate penalties, in the form of lower investment returns, potentially having an impact of 1% per annum, which over a long time frame can have a material impact on clients and/or members. This underscores the imperative for robust investment governance structures to safeguard against adverse consequences in an increasingly complex investment landscape.

Looking ahead, traditional investment governance practices may no longer suffice in navigating future challenges. While only a mere 3% of respondents viewed the current investment governance landscape as marginally worse than a decade ago, there is a growing recognition that historical approaches may not adequately address emerging complexities. As such, it becomes imperative to identify key ingredients for fostering effective investment governance in the future.

Investment governance emerges as a multifaceted challenge, particularly for large asset owners grappling with the rapid pace of industry evolution. The survey findings indicate a consensus among approximately 92% of respondents that investment governance has become increasingly complex over the past decade. This complexity manifests across organisational structures, necessitating tailored approaches to address investment governance challenges.

The complexity of investment governance extends beyond large asset owners, with more than 94% of respondents acknowledging the heightened intricacies faced by smaller asset owners. This underscores the universality of investment governance challenges and the need for tailored solutions across organisational scales.

Furthermore, international markets offer invaluable lessons in investment governance best practices. While only 6% of respondents viewed investment governance as merely emulating global counterparts, the survey highlights the potential for cross-border insights into market diversity, innovation and risk management strategies. Such cross-pollination of ideas enhances organisational resilience and fosters a culture of continuous improvement.

As institutional asset owners navigate an increasingly complex landscape, the adoption of robust investment governance frameworks becomes paramount. By embracing transparency, fostering leadership and drawing insights from global markets, asset owners can better navigate investment governance challenges with confidence, positioning themselves for sustained success in an ever-evolving investment environment.

An overwhelming 68% of surveyed participants emphasised that asset owners with poor investment governance practices faced disproportionate penalties.

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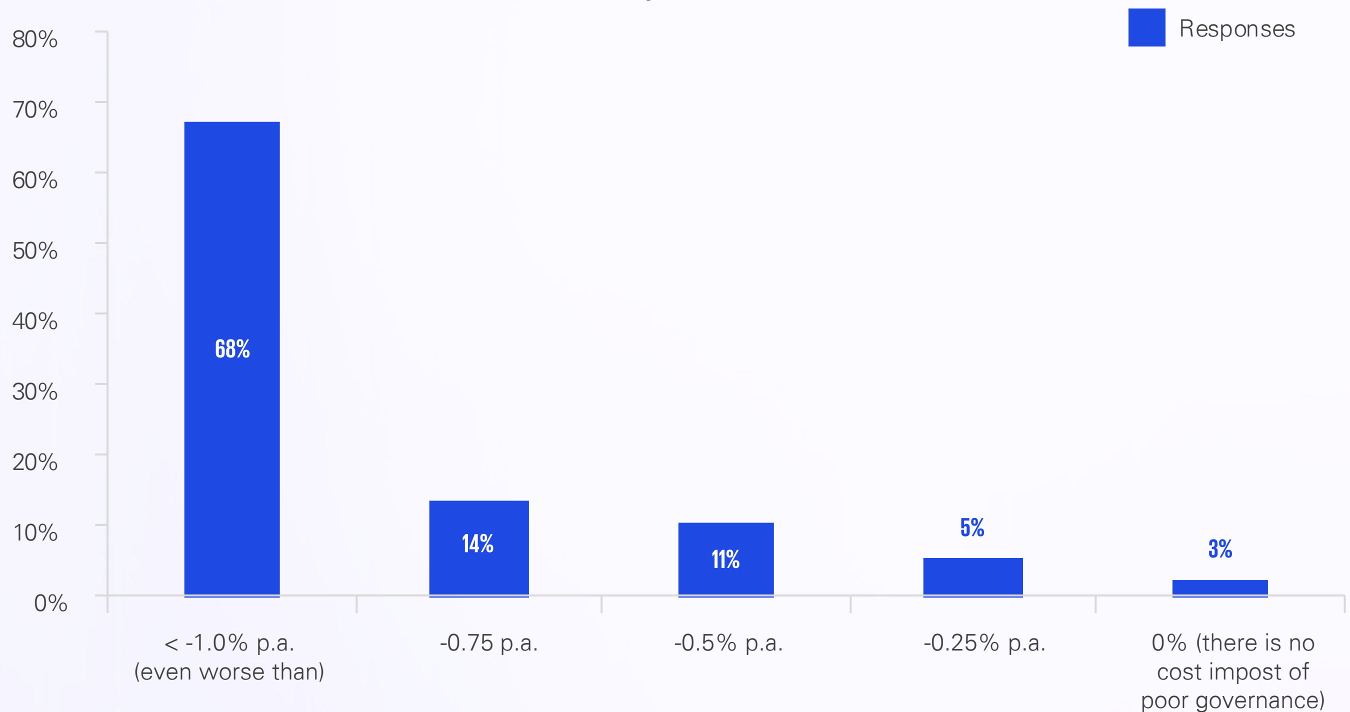
Why good governance is important and the difference it can make

There is a belief in 68% of survey respondents that asset owners with poor investment governance practices were disproportionately impacted (compared to the upside provided through good investment governance practices) resulting in return penalty of at least 1% per annum. So, what other reasons would an asset owner need to decide their investment governance practices should be improved?



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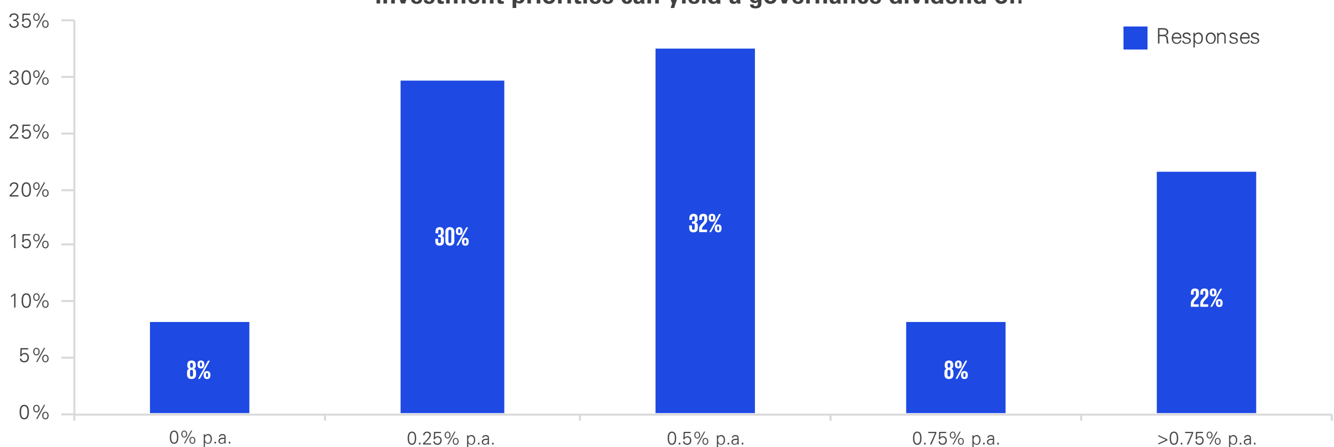
Investor protection

Good investment governance ensures stakeholders' interests are prioritised and protected. It establishes clear guidelines for institutional asset owners, including risk management protocols, investment strategies and disclosure requirements. By adhering to good investment governance practices, asset owners are compelled to act in the best interests of their stakeholders, minimising the potential for conflicts of interest or unethical behaviour, as we have witnessed in the past.

Enhanced performance

In the survey Frontier ran across institutional asset owners, 30% of respondents believe improved investment governance practices can yield a dividend of 0.75% or more per annum. By implementing effective risk management processes, aligning incentives with performance and fostering a culture of accountability, well-governed asset owners can enhance their competitiveness and profitability. Good investment governance also attracts top talent and fosters innovation, driving long-term value creation for stakeholders.



Market stability

Effective investment governance promotes market stability by mitigating systemic risks and market abuse. It imposes regulatory safeguards and compliance measures to prevent fraud, manipulation and misconduct within the industry. By maintaining market integrity, good investment governance contributes to overall financial stability, which is essential for investor confidence and sustained economic growth. In times of market volatility or crises, robust investment governance frameworks provide a safety net, helping to prevent contagion and systemic failures.

Long-term sustainability

Good investment governance is essential for the long-term sustainability of the industry. It encourages responsible investment practices; environmental, social and governance (ESG) considerations; and adherence to sustainable development goals. By incorporating these factors into investment decision-making, asset owners can generate sustainable returns while contributing to positive ESG outcomes, which benefits stakeholders and society as a whole.

Asset owners can generate sustainable returns while contributing to positive ESG outcomes, which benefits stakeholders and society as a whole.

Regulatory compliance

In an increasingly regulated environment, good investment governance promotes compliance with regulatory requirements and industry standards. The Australian Prudential Regulation Authority (APRA) Choice Heatmap gives us an annual insight in determining whether a fund is providing value and good investment performance for members. The impact to superannuation funds is on investment strategy and how funds consider primary objectives against the regulator-constructed benchmark portfolio. By staying abreast of regulatory developments and adopting best practices, asset owners can avoid costly fines, legal disputes and reputational damage.

Good investment governance is paramount as it safeguards stakeholder interests, promotes market stability, ensures long-term sustainability, enhances performance and facilitates regulatory compliance. By adhering to the principles of transparency, accountability and integrity, asset owners can build trust, attract capital (or new members for super funds) and create value for stakeholders.

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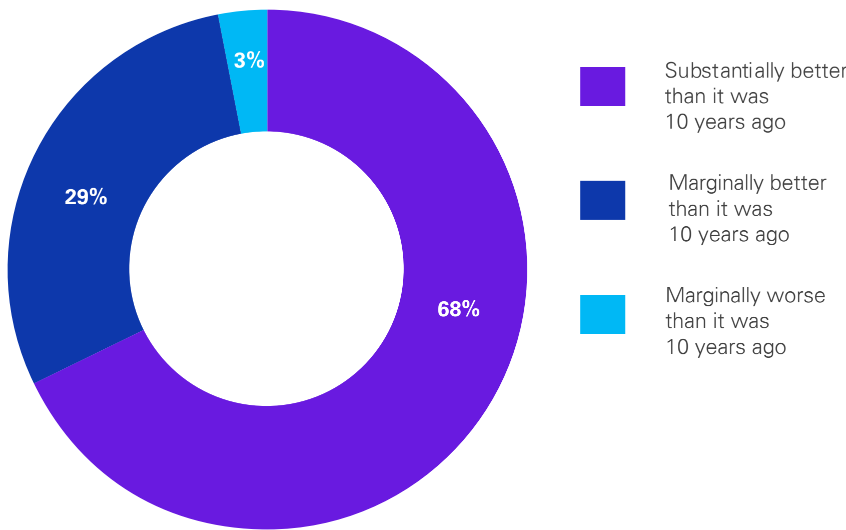
Investment governance practices for the future

In general, investment governance today in Australia is:



While only 3% of respondents believe the investment governance landscape in Australia is marginally worse than it was 10 years ago, governance practices which have served well in the past may not be as suitable for the future environment.

While it is challenging to predict the future with any certainty, the evolving landscape of technology, ESG, climate factors, and regulations (to name a few), coupled with the increasing globalisation of markets, will necessitate investment governance models/capabilities adapt and innovate.

Survey responses on what was the biggest area of threat to the future investment governance for an institutional asset owner identified that nearly one-third of respondents felt there is too much focus on the short term. Critical to future planning for investment governance functions will be consideration and critique of how the role and capabilities required will adapt and stay abreast of future changes.

Governance practices which have served well in the past may not be as suitable for the future environment.

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Potential considerations include:

- **Globalisation and complexity**
  Increasingly complex global markets driven in part by the interconnectedness of economies will require more sophisticated investment governance structures. Traditional investment governance models will need to be assessed to determine their ability to handle the growing intricacies and risks associated with global investments.

- **Sustainability and environmental, social and governance (ESG) factors**
  The importance of ESG factors will continue to increase, and investment governance models will need to grow and account for that change and development. Furthermore, consideration of the material financial risk created as a result of these increasing demands/expectations will result in certain models that don't adapt, becoming outdated.

- **Dynamic regulatory environment**
  Both the global and Australian investment management sectors are subject to constant regulatory change, either directly or indirectly. Investment governance models that are inflexible or slow to adapt will struggle to maintain pace and compliance with continued regulatory change, increasing risk on investment capabilities.

- **Data security and privacy**
  Recent evidence of cyber security breaches coupled with the ever-increasing threat of cyberattacks, necessitates a review with a clear focus and appreciation of the magnitude of risk such events can have on asset owners. Assessment as to the ability of current investment governance models to consider and address these risks will, if not already undertaken, require review and testing. Future investment governance models should incorporate cyber security policies, risk assessment protocols and board oversight mechanisms to protect sensitive information and safeguard stakeholder interests.

- **Agility**
  Traditionally, investment governance structures have been rigid and hierarchal. With the current, and likely future, environment presenting more VUCA[1] characteristics, investment governance models will need to exhibit the ability to be nimble and adapt.

- **Diversity and inclusion**
  A lack of diversity and inclusion in decision-making bodies can result in groupthink, unconscious biases and missed opportunities for innovation and growth. In the future, investment governance structures should prioritise diversity and inclusion, ensuring representation from diverse backgrounds, perspectives and experiences to drive better decision-making and culture.

[1] Volatility, Uncertainty, Complexity, Ambiguity

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Key ingredients for good future governance

Investment governance has been and remains an area which today is faced with challenges, perhaps more so than at any time in history. This is true for institutional asset owners of all shapes and sizes, regulators, directors, and executives.

Many asset owners continue to believe, in our view, that good investment governance is more correlated with compliance or process documentation and defendable processes (for regulators) than being necessary for true value-adding behaviours on behalf of all stakeholders.

Make no mistake: good documents, good processes, clarity within organisation, good communications, etc. are all valuable; however, we would see these as secondary in terms of key elements required for good investment governance.

In the Frontier survey conducted with institutional asset owners, we defined good governance as the capacity to add value from the combination of skills, resources, time and processes.

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The relationship of these factors is a multiplicative rather than additive one. That is, the total result will be impacted by the size of the smallest input. An organisation that has enormous skill and many people with those skills, but has either no time available or suitable processes in place to deploy those skills, will end up with a zero outcome.

Investment governance is evolving and there is no such thing as stationary best practice. Firstly, there is no single or universal way of achieving best practice and secondly, we need to recognise the constant evolution of investment governance. In seeking out better investment governance, the factors that are critical in leading to an optimal outcome are those which allow for more capacity either in each of the four building blocks of our equation or those which rebalance various items to focus on more important strategic items (which lead to a higher equation outcome).

In seeking out these factors, readers need to remember investment governance is not the same as corporate governance (although there are many overlaps) and is also not the same as ESG. Investment governance is singularly focused on how to deploy the above elements (which are finite and constrained) in order to achieve the best investment outcomes, balancing the wide and increasing criteria against which investments are judged.

There is a reasonable amount of literature, papers and thought pieces on investment governance and there are some repetitious themes within those. While many have sensible elements, they sometimes fail to convey why these factors are key and how they contribute to improved investment governance outcomes. In our view, it comes down to how each factor relates to the governance equation.

In the Frontier survey, it was conducted of institutional asset owners, it was recognised there is a very clear recognition of the potential value either derived or eroded from the gap between good and poorly governed funds.

- 62% of survey respondents said the dividend or benefit of good investment governance could amount to 0.5% p.a. or more over time.
- 68% of survey respondents said the return penalty of poor investment governance could be as much as -1% p.a. or worse over time (and 82% said -0.75% or worse).
- For example, in superannuation terms, for a new worker aged 25, joining employment and starting to save, the gap over a full working life could be as much as 40% or more (or $500,000 or more) in the expected difference between a fund with good versus poor investment governance. This is the view of asset owners, not Frontier or KPMG.

So, what are the key attributes needed for better investment governance in our view?

NO.	AREA	DESCRIPTION	WHY IT MATTERS
1.	**Clarity of mission**	– A clear understanding of the beliefs and priorities. These do not need to be locked in and can, and probably should, change over time but a very concentrated focus on the most important items (which can also vary by time period) is key. – A clear understanding of the trade-offs between various items. – A depth of knowledge and understanding of an organisation's competitive advantages and weaknesses (which can assist in understanding how an organisation may pursue these various goals and where it may partner).	Clarity enables organisations to assess on an ongoing basis what they need to focus on and where shortfalls exist – which then enables the efficient deployment of skills, resources and time to focus on those areas of highest importance. Interestingly, in Frontier's survey of asset owners, 1 in 10 people at every fund said not everyone understands the trade-offs and goals for their fund. Additionally, 1 in 10 said senior investment staff are not clear on key investment priorities in the next 1–3 years.

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2.	**Commitment to mission**	– The leadership team, the board, investment committee and the executive need to understand deeply the items above and have a collective and strong commitment to these.	Often in investments there are 'shiny ball' distractions – the latest theme or trend. There is also potentially a fair amount of FOMO. Being committed to a set of ideals, areas of focus and backing up the fund and the team on these areas is key. Again, doing so ensures the focus on skills, resources and time to those areas of highest importance, without short-term distractions or capturing time/resources or skills to efforts with a lower marginal value.
3.	**Challenge and diversity**	– It is vital the mission and key areas are reviewed periodically. – This may involve explicit challenges to existing paradigms, devil's advocates pushing counter cases, and more.	Secular forces change over time, regulation changes over time (for example, no super fund focused on Your Future Your Super (YFYS) five years ago and this now influences funds today) and the views, make-up and experiences of executives also change over time. It is important to debate, review and reassess the high-level mission and other elements periodically. Getting a diverse range of views, hearing these out and voting on aspects is important. But then, agreeing to a set of principles for the foreseeable future and having a collective backing by everyone is also important.
4.	**Incentives**	– Ensuring executives and board and investment committee members have genuine aligned interests with end members/stakeholders.	This is even more important given the multitude of different lenses applied to portfolios. Many teams are incentivised around alpha (outperforming benchmarks). Overall, we believe delivering on the commitment to members/stakeholders is most important (and this is often expressed as a real return). If key leadership have incentives (financial or otherwise) which create alignment with the mission, again this will ensure the greatest effort to those items which matter most. This is also part of the Financial Accountability Regime (FAR) legislative changes coming into effect in Australia and discussed further in our section on key areas of governance challenges.
5.	**Leadership, reflexivity and circularity**	– Strong leadership. – Looks at own gaps and objectively and openly assesses these. – Has an active improvement mindset. – Charts a path for continuous improvement.	Leadership comes from the top. Being clear on the mission, communicating it to all employees/staff, being clear on priorities and on the vision can both motivate staff (and members/stakeholders) and ensure time, effort and resources are focused on the things that matter most.

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Another key outcome of the survey was clarity of mission being an area where more work is needed.

As identified by **37%** of survey respondents, one of the biggest areas of threat to future investment governance for an institutional asset owner from a system-wide perspective was that funds today need to examine their portfolios through too many lenses.

Another concern, identified by **32%** of survey respondents, was that there is too much focus on the short term.

In fact, from the survey, the top two challenges voted on by participants from Australian institutional asset owners were:

1. Having a clear mission plan for investments.
2. Having a plan that everyone understands and buys into.

All of the above aligns strongly with the aspects outlined in our key attributes table above and the key ingredients we believe are necessary for good investment governance. So, the question is:

What are you doing about it?

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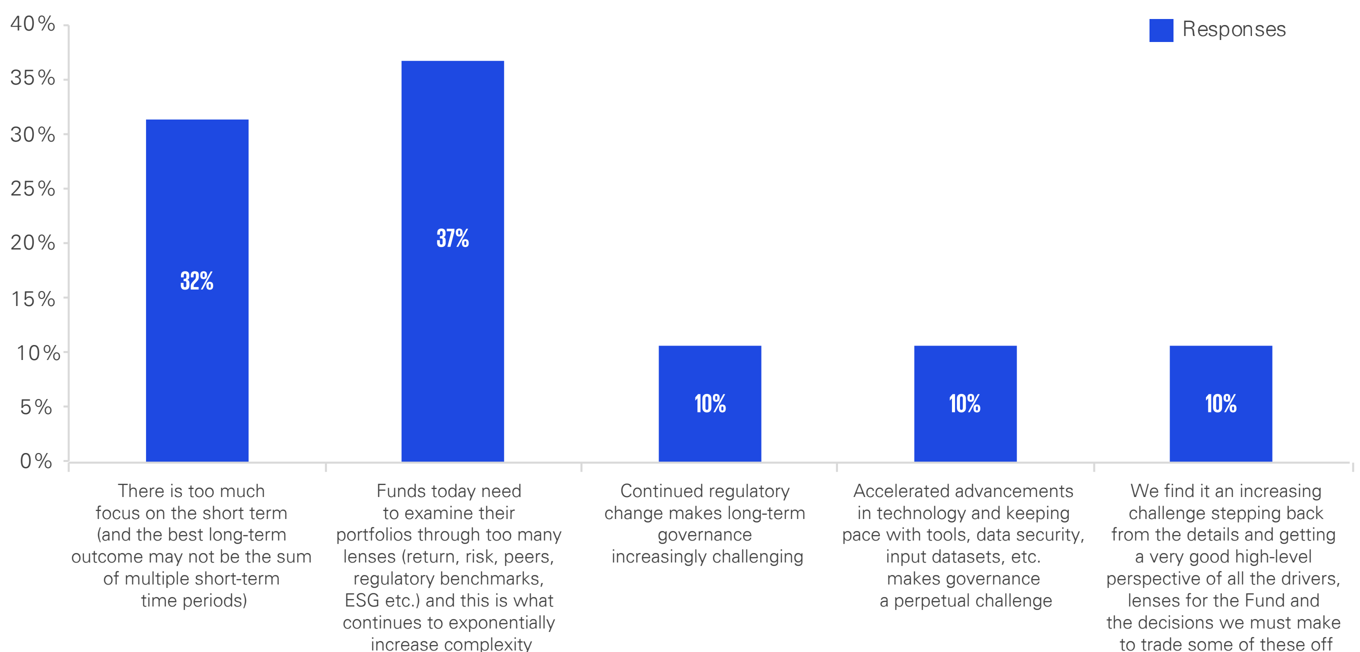
What asset owners need to stop doing

Both Frontier and KPMG's experience across the asset and wealth management sector is that the majority of asset owners undertake compliant and diligent investment governance functions. In providing this function, asset owners will have established frameworks and checks to ensure those practices which should not occur, do not (e.g. insider trading), while also being aware of emerging themes to improve and enhance their current practices.

The biggest area of threat to future governance for an institutional asset owner from a system-wide perspective is:



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Identifying areas where asset owners need to stop certain practices is crucial for optimising performance, enhancing investor confidence and ensuring long-term sustainability. While several practices warrant reconsideration and cessation within the investment management industry, the survey found the main themes which threaten future investment governance are increased complexity in examining portfolios (37%) and too much focus on the short term (32%). So, what do asset owners need to stop doing?

1. Excessive risk-taking

- **What to stop:** Asset owners need to prevent excessive risk-taking behaviours that jeopardise investor capital and stability.
- **Why:** Over-leveraging, speculative bets and the pursuit of high returns can expose asset owners to unnecessary risks, lead to financial losses and increased scrutiny from regulators.
- **How to change:** Asset owners should embrace prudent risk management practices, diversify portfolios and implement rigorous risk assessment frameworks to protect investor assets and preserve long-term value.

2. Neglecting ESG considerations

- **What to stop:** Asset owners must stop neglecting ESG considerations in investment decision-making.
- **Why:** ESG considerations are increasingly important for investors. Ignoring them can lead to reputational risks, legal challenges and missed opportunities for sustainable returns.
- **How to change:** Asset owners should integrate ESG considerations into their investment processes, assess ESG risks and opportunities systematically, and engage with companies on their value chain to promote responsible business practices and long-term value creation.

3. Opaque fee structures

- **What to stop:** Opaque fee structures that obscure the true cost of investing and erode investor trust should be abandoned.
- **Why:** Complex fee arrangements, hidden charges and excessive fees reduce investor returns and undermine transparency.
- **How to change:** Asset owners should embrace simplicity and transparency in fee structures, clearly disclose all costs associated with investing and align fees with value-added services.

4. Short-termism

- **What to stop:** Avoiding short-term thinking is particularly relevant for superannuation funds regulated by APRA, which has in part been forced on them by regulatory change and the prioritisation of short-term gains over long-term sustainability.
- **Why:** Short-term trading strategies, speculative investments and chasing market trends can lead to suboptimal outcomes for investors and increased volatility in portfolios.
- **How to change:** Asset owners should adopt a disciplined approach to investing, prioritising thorough research, prudent risk management and focus on investment beliefs and philosophy to create long-term fundamental value over short-term fluctuations.

5. Lack of diversity and inclusion

- **What to stop:** Establishing teams, decision making bodies and other sources of input that lack cognitive diversity.
- **Why:** Homogeneous investment teams, boards and decision-makers hinder innovation, diminish perspectives and perpetuate biases.
- **How to change:** Diversity and inclusion should be prioritised across all levels of the organisation, fostering a culture of belonging where diverse voices are valued and empowered to drive better outcomes.

6. Failing to embrace technological advancements

- **What to stop:** Resisting the adoption of new technologies and innovative tools in investment processes.
- **Why:** Technology can enhance efficiency, provide real-time data analytics and improve decision-making.
- **How to change:** Embracing technological advancements may lead to efficiencies and a competitive advantage.

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Key areas of governance challenges – large super funds

The last decade has brought with it a myriad of changes to the investment industry. Investment outcomes are now assessed through many different lenses. Most of the institutional asset owners we surveyed (~92%) agreed that investment governance has become increasingly complex over the past decade. The pace of growth and its impact on investment strategies can create a range of investment governance challenges.

While each institutional asset owner will have their own unique investment governance challenges, some are more prevalent amongst large institutional asset owners, including:

- Organisational culture
- Proper oversight of internal asset management
- Focus on a collective outcome
- Unlisted asset valuations
- Accountability for outcomes.

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Organisational culture

The right culture can be a key tool in achieving differentiation in a competitive environment. Culture is the set of values and behaviours of an organisation – it is the unwritten rules of how the organisation operates. Culture is 'what' people do. It is 'how' they do it. Most importantly, it is 'why' people do what they do. (Read more about organisational culture in this *Frontier Line* issue: The Karma of Culture.)

For large and growing institutional asset owners, organisational culture becomes an increasingly complex and challenging area. With an increasing number of staff, often across different office locations and increasingly in different geographies, it can become more challenging to maintain or evolve organisational culture and the key success factors that have driven the organisation to date. Maintaining or evolving organisational culture needs to be proactive and deliberate – it requires frequent monitoring and critical review.

Risk culture is also growing in stature as institutional asset owners become larger, the organisation becomes more complex, has more independent parts and processes, and it becomes a more vertically integrated business. To add to this, we are seeing greater public scrutiny and the regulators lifting the bar and expecting more – and APRA has been vocal on risk culture for some time (see APRA's Risk Culture 10 Dimensions and Transforming risk culture: observations from APRA's pilot survey).

Proper oversight of internal asset management

As large institutional asset owners grow, so too does the incentive for internal asset management, as the potential for lower fees and greater control over investments (amongst other benefits) can drive its appeal. While there are potential benefits of internal asset management, there are also potential investment governance risks – internal asset management requires robust oversight, review and challenge. Proper oversight is a crucial component, and as highlighted in Frontier's recent *Frontier Line* (Why asset owners need to strengthen oversight of internal funds management), the focus of the oversight should not only be on the investment teams but also on the investment models they use to drive their investment decisions.

Delegations, trust in those delegations and clear accountabilities also become increasingly important as institutional asset owners manage more internally, and it helps to ensure good investment risk management.

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Focus on a collective outcome

As institutional asset owners grow, teams can become more fragmented and risk operating in silos. So for large institutional asset owners, the importance of a common goal and alignment of mission is critical for success. Having a clearly articulated and understood common goal/mission is a key first step. People are a key factor in an organisation's success, and so being able to attract and retain the right people, who are also culture-aligned, should be a key focus.

Unlisted asset valuations

Unlisted assets have become a growing focus for both institutional asset owners and regulators as changing market conditions have amplified risks. For large institutional asset owners with exposure to unlisted investments – either directly, through a partnership arrangement, or via an external investment manager – these exposures are generally high, at least in absolute dollar terms. As large institutional asset owners increasingly find some public market investments more challenging to access (for example, due to capacity), private market investments can become more appealing.

Unlisted investments can add to investment management complexity and create unique valuation challenges for institutional asset owners, both under business-as-usual conditions and through periods of market volatility.

To manage these challenges responsibly and thoroughly, and to mitigate the associated risks inherent in unlisted investment valuations, valuation governance frameworks must be carefully structured and regularly reviewed. This ensures they are fit for purpose in a constantly changing regulatory environment. This challenge was explored in detail in a recent issue of *Frontier Line* (Unlisted asset valuations: ensuring fairness and equity).

For superannuation funds, valuations continue to be one of the focus areas of APRA. APRA recently released finalised standards and guidance on valuation governance (Prudential Standard SPS 530 and Prudential Practice Guide SPG 530 – Investment Governance), requiring regulated super funds to have, among other things, an appropriate valuation governance framework to enable the identification and management of valuation risks.

Accountability for outcomes

Poorly designed remuneration structures and accountability mechanisms can reinforce a poor risk culture and negatively impact the organisation and its stakeholders. Following the Final Report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, the Government announced the application of the now former Banking Executive Accountability Regime (BEAR) would be extended to cover all APRA-regulated entities (including the superannuation and insurance industries) and renamed the Financial Accountability Regime (FAR). There are 'enhanced' obligations under the FAR for large entities: for superannuation funds this applies to funds with >$10 billion in total assets; for general insurance and private health insurance the threshold is >$2 billion in total assets; and for life insurance the threshold is >$4 billion in total assets. This imposes a strengthened responsibility and accountability framework on the organisations, but also to the directors and senior executives as 'accountable persons'.

FAR will be coming into effect in the next 12 months for most entities, and investment governance considerations and analysis may likely be needed to address changes brought about by FAR.

Maintaining or evolving organisational culture needs to be proactive and deliberate – it requires frequent monitoring and critical review.

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Key areas of governance challenges across different organisations

Navigating challenges of investment governance is an arduous task faced by institutional asset owners, however, there is an understanding among 68% of survey respondents that poor investment governance will result in potential return penalties of more than 1% to returns. While the specifics may vary – across sector, size, processes, service delivery models, people, technology and data – several key areas consistently emerge as focal points for addressing issues in investment governance.

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1. Size and scale

While larger asset owners face challenges to maintain agility and responsiveness due to increased bureaucracy, smaller asset owners may struggle with limited resources to undertake comprehensive risk management and due diligence, particularly as the demands on them continue to grow (by virtue of more lenses on portfolios, more data, more regulation, and the like).

2. Processes

Although larger asset owners grapple with intricate investment governance and decision-making processes that sometimes hinder efficiency, some smaller asset owners may tend to lack formalised investment governance processes, which can lead to ad hoc decision making.

3. Service delivery models

Institutional asset owners that outsource investment functions may face challenges in ensuring complete alignment with their values and risk tolerance. However, relying solely on in-house capabilities can limit exposure to diverse perspectives and expertise. As organisations move up the value chain, there is a delicate balance between providing high-quality services, having robust investment governance practices and managing the associated costs.

4. People

Attracting and retaining talent continues to be a challenge for both large and small asset owners. This also impacts on having diverse representation in decision-making roles, with larger asset owners facing more intense scrutiny on board composition and investment governance practices.

5. Culture

Upholding ethical standards and fostering a culture of integrity are integral to effective investment governance. Institutional asset owners must promote transparency, accountability, and ethical behaviour at all levels, setting the tone from the top. Larger asset owners may experience issues with cultural alignment across geographically dispersed offices, while smaller entities may face challenges in establishing and maintaining a strong culture with limited resources.

6. Technology

While both large and small asset owners may struggle with integrating advanced technologies into existing systems, all organisations need to address the increasing threat and instances of cyber security breaches and data protection.

7. Regulatory compliance

Staying abreast of changing regulations poses challenges for asset owners of all sizes with regulatory requirements being resource-intensive, affecting smaller asset owners more significantly.

8. International operations

For larger asset owners, managing investment governance practices and investments across borders introduces complexities related to diverse regulatory environments, cultural differences, currency fluctuations and diverse market conditions.

9. Sustainability and ESG

Maintaining transparency in ESG practices remains a challenge across different organisational sizes, and embedding ESG considerations into investment governance practices can be challenging for asset owners that have varying levels of commitment.

10. Communication and stakeholder management

Engaging with diverse stakeholders, including shareholders, employees, customers, and communities, is essential for building trust and fostering long-term relationships. Effective communication channels and mechanisms for soliciting feedback are crucial for understanding investor expectations and addressing their concerns. However, striking a balance between transparency and confidentiality while managing competing interests can be challenging. Larger asset owners may struggle with communication breakdowns across departments, while smaller asset owners may face difficulties in reaching a broad range of stakeholders with limited resources.

11. Risk management

Identifying, assessing, and mitigating risks is fundamental to effective investment governance. From cyber security threats, to market volatility and operational disruptions, asset owners must proactively manage a multitude of risks to safeguard investor interests. While larger asset owners may have robust risk management frameworks in place, smaller asset owners may find it challenging to allocate sufficient resources to risk mitigation efforts.

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The importance of the investment committee (IC) chair

The role of the IC chair has become increasingly important and the difference a good chair can make is substantial. In our view, the most successful IC chairs encourage and elicit robust and balanced discussions, allow everyone to have a voice, and are strong but fair.

Frontier's survey of institutional asset owners shows the biggest areas of threat to future investment governance for an institutional asset owner from a system-wide perspective are:

- Institutional asset owners today need to examine their portfolios through too many lenses (37%).
- There is too much focus on the short term (32%).

Today, there are many competing priorities an institutional asset owner must contend with. While these will vary depending on the type of institution and/or whether it is regulated or not, we would agree the investment governance landscape is becoming more complex.

In terms of the most critical challenges for institutional asset owners today (ordered from most critical to least critical), respondents thought these were:

1. Having a clear mission plan for investments.
2. Having a plan that everyone understands and buys into.
3. Resourcing overall.

In challenging times, it all comes down to the investment governance foundations – are they robust enough? Establishing clear investment governance guidelines and regularly reviewing them is key for a successful institutional asset owner to overcome challenges as they inevitably arise.

Being disciplined in regularly reviewing investment governance guidelines ensures everyone around the table knows exactly where they are going and how they will get there – there is no ambiguity. A common challenge is when the destination becomes less clear, there are unplanned detours, where confidence in the mission or direction wavers (or is not cemented as being front of mind) or the destination changes mid-journey without due consideration of the flow-on effects (i.e. guided by a single lens/purpose without understanding the trade-offs).

Common answers on how to improve investment governance include:

- Education and training
- Improving team dynamics (e.g. better information sharing)
- Clarity of mission
- Board skills mix.

Investment governance arrangements are not a 'set and forget' construct and they must evolve as the institutional asset owner evolves. As we explored earlier in the key ingredients for future governance section, it is about finding the right balance of skills, resources, time and processes.

In challenging times, it all comes down to the investment governance foundations – are they robust enough?

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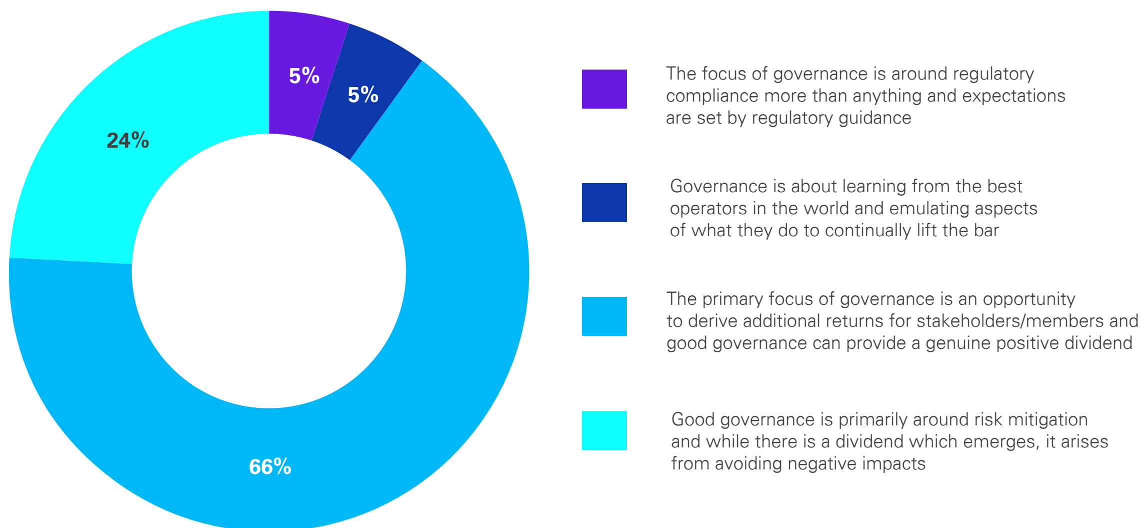
Learnings from international markets

An effective investment governance framework is one that is developed and evolved over time, and is fit for purpose for each asset owner as they are unique in their investment management style, arrangements and operations. This is evident in the survey results in which only 6% of respondents believe investment governance is about learning from the best operators in the world and emulating aspects of what they do. Taking learnings from international markets provides institutional asset owners with invaluable insights into market diversity, innovation, risk management and partnerships.

When we think of governance as a concept, which of the following statements most represents your fund:



The market insights from international asset owners further highlighted there have been continuous evolution of investment models (insourcing/hybrid) and strong focus on how asset owners can improve investment decision-making and conduct investment oversight.

In particular, asset owners that have shifted their investment model and operations from a heavily outsourced model to an internalised model or a hybrid model, have done so based on four key motivators for internalisation.

These include:

- Improving access to investment opportunities
- Addressing mandate capacity constraints
- Improving the alignment of long-term investment objectives
- Reducing management costs.

As these asset owners have continued to review/revise their arrangements, some asset owners have recently shifted their thinking/strategy in terms of their organisational capabilities and how they can better leverage external providers across investment management and investment operations, rather than owning/being responsible for these capabilities and functions.

The change or evolution of investment models from an outsourced model to an internalised model to now more recently a hybrid model, has required these asset owners to uplift their investment governance frameworks to ensure the framework appropriately reflects the current investment model.

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Some of the challenges these asset owners face include ensuring the appropriate oversight of internal teams and external providers are in place, in particular:

- Strong internal capability to check and challenge external providers
- Independent oversight and scrutiny of internal investment teams.

KPMG's annual flagship Evolving Asset Management Regulation report brings together a wealth of global insight to regulatory priorities, developments and proposals that impact the asset management industry. This includes how good governance is defined. We will draw out two items explored within Section 7 of the 2023 edition in respect of defining good governance, with our focus here being on priorities handed down from regulators overseas:

- Regulators are establishing regimes to make organisations and their senior leaders more accountable. The Financial Conduct Authority (FCA) Senior Managers and Certification Regime (SMCR) expects senior leaders to develop and nurture healthy cultures in the firms they lead and describes cultures as being 'purposeful' where sound controls and good governance are in place. In Asia, the Monetary Authority of Singapore (MAS) has issued guidelines to strengthen the accountability of senior managers with China's new compliance requirements for senior management of private fund managers in the Private Fund Regulations.
- We are also seeing a heightened focus on diversity, equity and inclusion by regulators across the world. The Central Bank of Ireland (CBI) has highlighted that given diversity is interconnected with risk, resilience, and financial performance, this as an area of great importance for Irish organisations. The Financial Sector Conduct Authority (FSCA) in South Africa published its Financial Inclusion strategy to promote the development of an innovative, inclusive and sustainable financial sector. In the UK, the FCA and Prudential Regulation Authority (PRA) have published consultation papers to improve diversity and inclusion in the financial services sector, including asset managers.

International asset owners are evolving their investment models, shifting from outsourced to hybrid or internalised models. This evolution necessitates an uplift in investment governance frameworks to reflect the current model, with challenges including ensuring appropriate oversight of internal teams and external providers, and engagement from regulators.

The Central Bank of Ireland (CBI) has highlighted that given diversity is interconnected with risk, resilience, and financial performance, that this as an area of great importance for Irish organisations.

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Are the key lessons here applicable to smaller asset owners?

There are different challenges for institutional asset owners along the size spectrum and each has their own investment governance challenges. As investment governance lessons and insights can be drawn from different jurisdictions and sometimes different industries, so too can lessons and insights be drawn by smaller institutional asset owners from larger institutional asset owners. The reverse may also be true, but that is for another discussion. Some aspects might be directly applicable whereas others may serve as a good cautionary tale.

For smaller institutional asset owners, the most applicable lessons might depend on whether they are growing and want to become a larger institutional asset owner over time or are a smaller institutional asset owner interested in how the big end of town has dealt with certain issues where these larger asset owners may have already tackled and addressed challenges being faced by smaller asset owners in the present.

As we dissect the key lessons gleaned from critical themes in investment governance, the question arises: are these lessons applicable to smaller asset owners? The resounding answer from KPMG and Frontier is: absolutely.

With the increase in reporting for larger institutional asset owners, the need for focused reporting becomes more acute, while not losing the ability to access all the detail.

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Public scrutiny on ESG/responsible investment issues

This has been a focus of public scrutiny for many different institutional asset owners in recent years and particularly so over the past 12-18 months, with some potentially caught off guard in terms of messaging and communication. This can trigger a point of reflection for smaller institutional asset owners to take a step back, go back to fundamentals and clearly establish: what do we believe, what are our goals, what will we do, what won't we do and how will we get there?

Public scrutiny generally – more disclosure

As institutional asset owners are increasingly required to disclose more and more, it is important to ensure any relevant messaging around it is universally understood and communicated. As brand and reputation are important for institutional asset owners of all sizes, appropriate disclosures and agreed communication of those disclosures is key.

What do we believe, what are our goals, what will we do, what won't we do and how will we get there?

Transparency and accountability

Moreover, transparency and accountability are non-negotiable principles in investment governance. Whether an asset owner manages more than $100 billion or less than $1 billion, maintaining clear records, documenting investment decisions, and regularly communicating with stakeholders fosters trust and confidence. Smaller asset owners can emulate this by maintaining transaction records, tracking performance and seeking professional advice when needed. By adhering to these principles, smaller asset owners can navigate market fluctuations and regulatory changes with greater ease.

Board/committee papers – information overload

Gone are the days where every paper that went to the board/committee was a short (or not so short) story. With the increase in reporting for larger institutional asset owners, the need for focused reporting becomes more acute, while not losing the ability to access all the detail. Larger institutional asset owners typically aim to focus meeting time on matters of importance and key decisions. A more focused meeting helps to ensure time is spent on the most important matters.

Board diversity and board skills

Ongoing board education and training is critical for an institutional asset owner of any size, and something that can be implemented fairly easily. Whether it be via individual or group education and training sessions, and being delivered formally or informally, it is key in a rapidly evolving investment governance landscape. Whether it be investment-related themes, regulatory-focused or industry-specific, it will always be time (and money, if applicable) well spent.

Monitoring and oversight

Another pivotal lesson from investment governance is the importance of monitoring, due diligence and oversight measures. Large institutional asset owners have dedicated committees and expert advisers to scrutinise investment opportunities and monitor portfolio performance. While smaller asset owners may lack such resources, they can leverage technology and research tools to conduct thorough analyses and stay informed about market trends.

The key lessons derived from investment governance are not exclusive to the larger players in the market. They are universally applicable principles that transcend portfolio size. One point to make very clear is that smaller is not necessarily a disadvantage, despite what the regulators will have us all believe. Smaller institutional asset owners can and do have competitive advantages, and for them it's about understanding what these are and then harnessing them.

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How to get started on the governance construct for the future

The most important thing is for an institutional asset owner to be open about itself. Where does it currently sit and where does it want to get to? It is important to collect feedback, openly, from various key stakeholders.

It is important to get started and initiate action. Action is needed to improve investment governance but also to sustain investment governance. It does not occur organically. From the survey of asset owners in Australia, the average self-ranking of investment governance was 7.7 out of 10. That is not bad, but even that requires effort to sustain and even more effort to improve.

Rather than starting or anchoring to where an asset owner is now or where you have come from, it is best to consider the starting point and, more importantly, the vision of where you want to get to. The key is then to charter a disciplined, step-by-step course to navigate from the start to the desired destination. Like governance itself, this will take time, resources and skills and cannot occur organically without commensurate effort and these three key inputs.

Effective investment governance is paramount for institutional asset owners to thrive in today's dynamic and complex financial landscape. Globally and in Australia, the forces acting on investors today may not have even been present 10 or 20 years ago and this will continue to change, e.g. AI, ESG and YFYS. Establishing a robust investment governance framework can assist investors to tackle the challenges in a strategic way.

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Below are some helpful steps that may assist in this regard as a start. These intentionally link back to the section on good governance traits.

1. Assessment of current investment governance structure

Conduct a comprehensive assessment of the existing investment governance structure, including policies, procedures, and decision-making processes. This evaluation should encompass board composition, roles and responsibilities, accountabilities, committee structures, and compliance frameworks. It is vital for the asset owner itself and key stakeholders to identify strengths, weaknesses, and areas for improvement to inform subsequent actions. To learn and independently review where you are at, it is useful for third parties to objectively assess this and compare and contrast your organisation to others.

2. Clarification of organisational objectives and goals

Clearly define the organisation's mission, vision and values to align investment governance practices with strategic objectives. Establishing a shared understanding of core principles fosters ethical conduct, promotes accountability, and guides decision-making. Ensure that investment governance mechanisms prioritise long-term sustainability and stakeholder interests over short-term gains. This connects back to the concept of trade-offs and time horizons noted in the earlier section on good governance traits.

3. Stakeholder engagement and dialogue

Foster constructive engagement with stakeholders, including members, employees, regulators, the investment committee, executive and the board. Solicit feedback, address concerns, and incorporate stakeholder perspectives into decision-making processes. Cultivate a culture of openness, responsiveness and dialogue to build mutually beneficial relationships and enhance organisational resilience.

4. Alignment of incentives and compensation

Align incentives and compensation structures with long-term value creation and risk management objectives. Design performance metrics that incentivise responsible behaviour, innovation and sustainable growth. Avoid short-termism by emphasising qualitative factors, strategic objectives, and non-financial criteria in compensation arrangements. Again, these should be independently reviewed and measured.

5. Continuous monitoring and reflection

Establish mechanisms for continuous monitoring, evaluation, and adaptation of investment governance practices. Review annually whether any practices which do not align with missions, competitive advantages or where new challenges have arisen which may warrant a formal inclusion in the mission focus. Regularly review policies, procedures, and performance metrics to ensure relevance, effectiveness, and compliance with evolving regulatory requirements. Embrace a culture of continuous improvement and innovation to navigate uncertainty and drive sustainable outcomes. But this does need to be accompanied by a prioritisation or hierarchy of needs.

6. Responsibility and accountability regimes

In recent years regulators have implemented regimes which focus on responsibility and accountability, notably the FAR and YFYS. While extending and strengthening the BEAR, FAR imposes an increased responsibility and accountability framework for APRA-regulated entities, including organisations in the superannuation industry. FAR applies to directors and senior executives of these entities, strengthening and increasing individual and entity level accountability. Although the YFYS regime may be subject to change in its current format, one of the original aims of the regime was to increase accountability and transparency by focusing trustees and directors to act in the best financial interests of members.

Institutional asset owners should undertake a readiness assessment in preparation for FAR implementation and keep abreast of any changes to YFYS.

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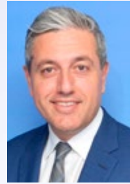

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