SmarterInsight

Ongoing governance of the investment process

Investing is not a set-and-forget process; new theory, empirical evidence and product development keeps an Investment Committee on its toes, on a client's behalf. By wearing a risk hat, instead of a performance hat, advisers can ensure that a client's portfolio remains structured to weather all storms, and avoid the dangers of investing in 'hot' markets and managers. Perhaps unsurprisingly, this risk-based approach often results in little portfolio activity, despite all the work that goes on behind the scenes.

Client Communication 40

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> *'The most treasured asset in investment management is a steady hand at the tiller.'*
>
> *Robert Arnott. – Founder and CEO of Research Affiliates*

'If it ain't broke, don't fix it!' as our American friends might say…

For investors who adopt a systematic buy-hold-rebalance approach to investing, it can be tempting to question why the portfolio seems to be largely unchanged from one period to the next. Some clients may even be tempted to question what their adviser is doing for his or her fee. That would be unfair and also brings into question the investor's understanding of why such an approach gives them the greatest change of a good investment experience. This short note seeks to revisit the value of such an approach, and provide an insight into the important governance process that goes on behind the scenes in the firm's Investment Committee.

Wear a risk manager's hat, not a performance manager's hat

A good place to start is to look at the investment process, not from a performance perspective – as most stock brokers and investment managers tend to do - but from a risk perspective. A simple example of the folly of being blinded by performance is no better illustrated than by the Ponzi scheme run by Bernie Madoff that stole $65 billion of client monies that finally collapsed in 2008. Those looking at his fund with a performance hat on loved the 10% year-on-year performance with no volatility (there's a clue!). Culprits included HSBC, Royal Dutch Shell, Allianz Global Investors and UBS, to name and shame a few. Those with their risk manager's hat on spotted the fact that the custodian was Bernard L. Madoff Securities LLC and the auditor was a two-bit accountancy firm run by a good family friend, and avoided it like the plague.

The flip side of return is risk. If you focus on attractive returns, you are at risk of taking on unknown or poorly understood risks. If you focus on risk – taking on only risks that are understood and adequately rewarded – you provide yourself with every chance of a successful outcome, although, in investing, nothing is ever guaranteed.

If you ask many investors what the definition of a good portfolio is, they will respond that it is one that has performed really well. Yet, inevitably, that is something that can only be measured retrospectively. In our view, a good portfolio is not about generating the best performance (with hindsight), but about how well the portfolio is likely to survive a wide range of market scenarios ahead, that it may face.

> *'Never forget the six-foot tall man who drowned crossing the river that was five feet deep on average. The important thing to remember about investing is that it is not sufficient to set up a portfolio that will survive on average. The key is to survive at the low ends.'*
>
> *Howard Marks, billionaire and founder of Oaktree Capital Management*

Your portfolio, as it stands today, should provide you with the comfort that it is robust under the wide range of testing scenarios that could be thrown at it by the markets. As an extreme example of a performance-driven approach, a portfolio or Russian smaller company stocks might well perform spectacularly from time to time, but few would believe that that is a sensible long-term investment strategy to weather the uncertainty of the future. Believing that employing a professional fund manager can protect a portfolio by positioning it in advance of market movements is a myth. The evidence simply does not support the notion.

> *'Short-term clients look for gurus. Long-term clients want sages. There are no gurus.'*

Harold Evensky, president of Evensky & Katz, author

Owning a risk-based portfolio makes great sense, but can seem a little dull

Our approach to building client portfolios is driven by risk management. We ask ourselves if we want to take, avoid, reduce or transfer the plethora of risks that investors face. These are the only four courses of action available to us. Each of these decisions is grounded in the academic theory and empirical evidence that is available to us. Let's consider some of the key risk decisions that have been made when establishing client portfolios.

Key decision 1: own a highly diversified pool of global companies to avoid concentration risks

The fortunes of individual company stocks, industry sectors e.g. oil & gas, or individual stock markets can vary dramatically. Owning a broad exposure to thousands of companies, in all sector and in (most) stock markets around the world, provides an investor with the chance to capture the broad dynamism and wealth creation of capitalism. Narrow exposure to companies, sectors and countries is a risky strategy requiring manager skill to execute well in all market scenarios. The evidence tells us that such skill is both rare and very hard to identify in advance.

Key decision 2: tilt the portfolio toward higher risks to pick up higher returns

Empirical research suggests that smaller companies and those with value characteristics (often less glamourous stocks that are financially less healthy) deliver returns over and above the broad markets, most likely due to the higher risks they entail. Taking some extra risk to try to capture this incremental is a reasonable course of action. The downside is that extended periods of time have existed – and will exist - when these companies underperform the broad market. On balance, tilting portfolios toward these characteristics makes sense, when done in moderation.

Key decision 3: own shorter-dated, higher quality bonds to balance equity downside risk

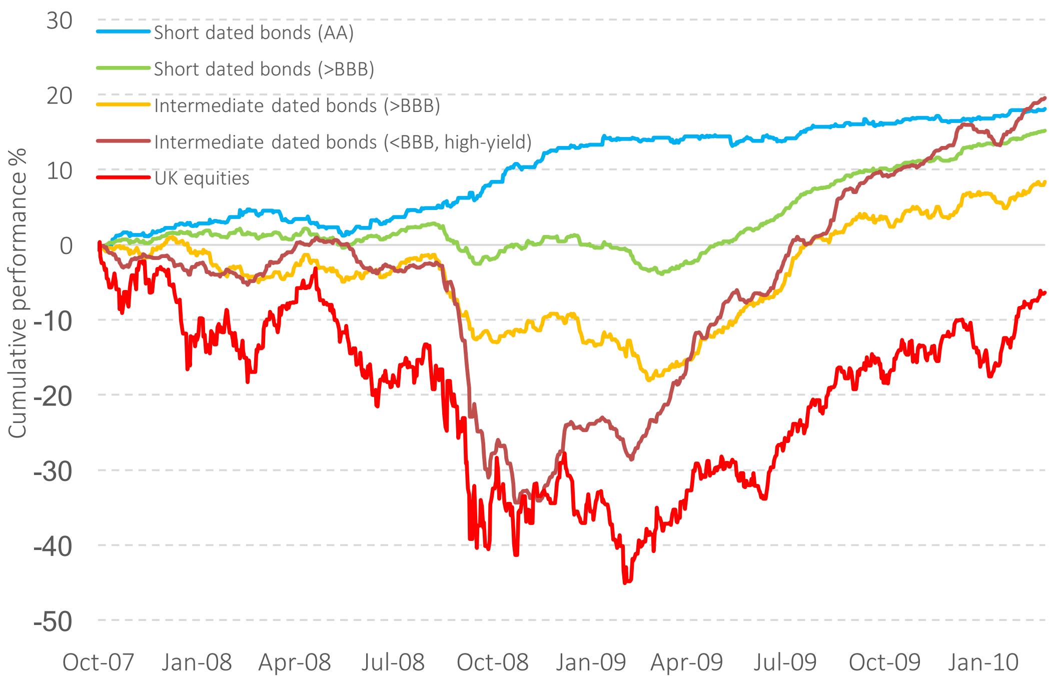
Short-dated, high quality bonds bring strong defensive characteristics to portfolios, as they are far less volatile than equities and exhibit returns that may even be negatively correlated to equities, from time to time. Investors who cannot stomach a 100% equity portfolio – very few can – need to take some of the risk of material losses off the table, which is achieved by owning bonds.

> *'You shouldn't own common stocks if a 50% decrease in their value in a short period of time would cause you acute distress.'*

Warren Buffett, CEO, Berkshire Hathaway

At present, with bond yields at historical lows, bonds are delivering low returns. Those with their performance hats on may well get tempted into investing in bonds that offer higher yields (because they are more risky), to up the performance on this part of the portfolio. The adviser wearing a risk hat asks him or herself why they own high quality bonds in the first place. The answer is to protect against awful times in the equity markets. The chart below provides insight into this risk decision. Lower quality, long-dated bonds act like equities at times of market crisis. Money flees these riskier assets pushing prices down, while shorter-dated high quality bonds act as safe havens, attracting the scared money, pushing prices up.

Figure 1: Lower credit quality bonds fail to provide defensive cover when equities crash



Source: Morningstar Direct © All rights reserved. Indices used: BBgBarc UK Gilt 1-5, Markit iBoxx GBP Corp 1-5, Markit iBoxx GBP Corp, BBgBarc Global High Yield, MSCI United Kingdom.

Key decision 4: use systematic rather than judgemental fund managers

Choosing which funds to recommend to clients is a big responsibility that all good advisers take very seriously, employing a detailed and insightful due diligence process to ensure that the right questions are asked of product providers. The focus should always be on risk management that starts with eliminating fraud, explores operational risks, focuses on product structure risks and then finally looks at the ability of the fund firm to deliver market returns effectively.

Although picking a manager who promises to beat the market – who uses his or her judgement to identify short-term market trends and stock prices - sounds appealing, the stark reality is that true skill is hard to discern from luck, it is extremely rare, and it is almost impossible to identify in advance. Looking at an ever growing body of evidence, it is evident that employing managers who adopt a systematic (rules-based and disciplined) approach to capturing the returns delivered by taking on specific market risks makes good sense. At their simplest, these may be index tracker funds capturing the returns of broad markets or more complex systematically managed funds seeking, for example, to pick up the size or value premium by isolating companies in the market with these characteristics.

Key decision 5: avoid owning an increasingly risky portfolio by rebalancing

Over time, the more risky assets (equities) in a portfolio tend to rise in value and begin to overpower the more defensive assets (bonds) in the portfolio, and the risk level starts to creep up. Periodically realigning - or rebalancing – a portfolios back to its original structure avoids this risk.

'The fundamental purpose of rebalancing lies in controlling risk, not enhancing return. Rebalancing trades keep portfolios at long-term policy targets by reversing deviations resulting from asset class performance differentials. Disciplined rebalancing activity requires a strong stomach and serious staying power.'

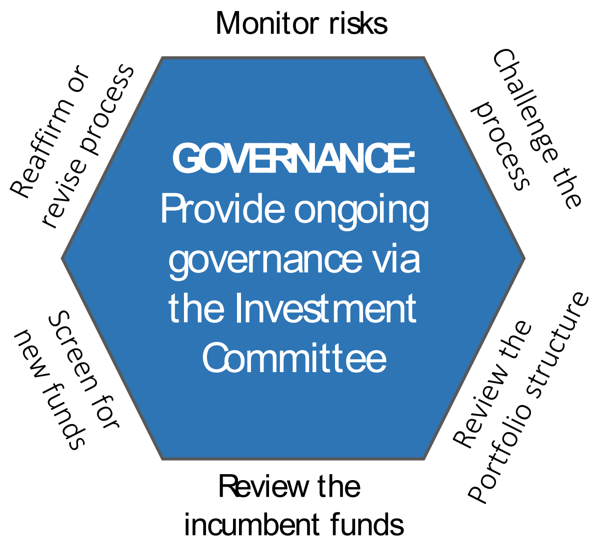
David Swenson, CIO, Yale University Endowment

Rebalancing involves selling out of better performing assets and buying less well performing assets i.e. selling, rather than buying 'hot' performing asset classes. This enforces a systematic, rather than a market valuation based, defence against possible market bubbles. Rebalancing is simple in concept, but in practice it is hard to do; it requires considerable discipline and fortitude, particularly at times of market turmoil, when our emotions, particularly fear and greed, are heightened.

The role of the Investment Committee

It is perhaps evident that a firm's Investment Committee should be focused predominantly on the risks that have been taken in the portfolio – both at portfolio structure and at a fund level – rather than discussion whether now is the time to jump in or out of markets or which manager to hire and which to fire. The figure below highlights the key areas that the Investment Committee is responsible for.

Figure 2: Key areas of responsibility of the Investment Committee



Source: Albion Strategic Consulting

A formalised process for discussion and managing risks

The firm's Investment Committee is responsible for the oversight of the risk in portfolios and the wider investment process. Meetings are held regularly and minutes are taken, which include all action points to be followed up on. Third-party inputs and guest members provide valuable independent insight, where necessary.

Responsibility 1: ongoing challenge to the process

The investment process at the firm is driven by the latest empirical evidence and theory available. It is always open to challenge. If new evidence suggests that doing things differently would be in clients' best interests, then the firm will revise its approach. The investment process is evolutionary, but change is most likely to be slow and incremental.

Responsibility 2: review of the best-in-class funds recommended

The incumbent funds are best-in-class choices which have been identified to deliver the returns due from taking on specific market risks. Each fund has a role to play in a portfolio and its ability to deliver against this objective is regularly reviewed. Any fund-related issues are raised and resolved, although this is pretty rare.

Responsibility 3: review the portfolio structure

The underlying characteristics of the firm's client portfolios are reviewed regularly, including performance and risk level attributes. Risks (asset class exposures) and their allocations within a portfolio are evaluated and from time to time these may change as the firm's thinking evolves, given the latest evidence. Any portfolio-level issues are raised and resolved.

Responsibility 4: screen for new funds

New products are regularly being launched. Tough screening criteria are in place against which all funds – incumbent and new - are judged. New, potential best-in-class funds face detailed due diligence and approval, before they are recommended to clients. They are included only when they make the grade. It would take a material improvement to knock an incumbent fund off its perch, but it can and does happen from time to time.

Responsibility 5: reaffirm or revise the investment process

The Investment Committee is accountable for reaffirming or revising the structure of client portfolios. Risk (asset) allocations and fund changes are approved by the Investment Committee. Any actions arising from portfolio revisions will be undertaken, after discussion with - and agreement by - clients.

Conclusion

It is entirely possible, and likely, that your portfolio will look much the same between one-time period and the next with little activity, except for rebalancing. That most definitely does not mean that nothing is happening. The firm holds regular Investment Committee meetings. If it adopted an active management approach, these meetings would be taken up with economic analysis, forecasts for markets, tactical short-term market timing decisions and fund picking choices. Meetings are far less exciting, focused on reviewing any new evidence supporting or challenging the approach, the latest research on asset classes, and additional due diligence ensuring that the best-in-class funds remain just that.

It takes quite a lot of work to keep our portfolios the same! Keeping our risk management hats firmly on our heads, we avoid the siren song of rapidly rising markets and 'hot' fund managers that dash those with their performance hats on, onto the rocks of market timing and stock and manager selection.

Other notes and risk warnings

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