Made to Measure

It was Benjamin Franklin who noted that *an investment in knowledge pays the best interest* – which seems a fitting start to this ramble, and follows on from my recent participation in the age-old debate of active versus passive investing. Without reliving this, the support towards active was countered with a passive argument of “everyone is doing it, so it must be right”. It got me thinking, that an alarming reason behind the shift from active to passive investing is that it’s easier for the industry (both in advice terms and in the management of), and permits a struggling intermediation community to preserve their margins during a time of lower portfolio performance.

This is happening at a time when the industry is buckling under the weight of ‘active investment’ choices, justifying any portfolio tilts in this area with “research” (and I use this word loosely) such as:

a. They are likeable people, and it’s good to support them
b. They speak/spoke/support our conference
c. They are constantly in the public arena and tend to make sense
d. That’s what/who I’ve always used (with one regional advisor unable to explain why they used these Managers in the first place!)
e. I simply don’t have the time to filter through all the assorted options and choices

Whilst I acknowledge that many of these responses were common-place in the heady-days, the luxury of ‘relationship-based’ appraisals (at best, “complacency” at worst) is now unacceptable, with investors expecting a well-considered portfolio to reflect their wealth ambitions, in exchange for the fees that they’re paying. The commoditisation of passive investment gateways will place increasing pressure on the “point, shoot and charge” portfolio construction philosophy that is the default for some advice participants, as consumer’s preferences for cheaper low-value disintermediation continues to escalate.

Whilst there is plenty of external research on larger more established active Managers in comparison to newer boutiques and capabilities, much of what is available is still a better starting point than the relationship-centric responses mentioned above. “Starting point” being the key phrase, with the largely quantitative appraisals by the research houses a useful mechanism to help compress a large volume of information into a few digestible pages.

Even with this quant data now readily available, there are few advisors who seek to understand the performance attributes of an investment capability, or what conditions must be present for the Manager to meet their performance & risk expectations. And then there are those advisors who choose to believe that markets are efficient, and that the industry is unable to add any meaningful value in the construction of portfolios. For the sake of repetition, the latter community are merely acknowledging their own failings in adding value in portfolio construction, and will find it increasingly difficult to exchange their other services for the same ongoing fee.

To remain relevant, the advice industry must be able to justify their use and/or retention of the various investment constituents that make up their portfolios. They must be able to explain why the components of a portfolio's performance differed from the benchmark using analysis referred to as Attribution. Performance attribution interprets how investors achieve their performance and measures the sources of value added to a portfolio. In other words, it relates the excess returns of the portfolio (both positive and negative) to the active investment decisions providing feedback on why it either outperformed or underperformed its benchmark.

The most generic form of attribution decomposes the performance of an investment capability against a passive alternative to measure exactly the amount of value that is added by the underlying investment decisions. This approach can focus on allocation (top down approach) or selection (bottom up approach), is relatively easy to understand, and is widely accepted in the industry. This is referred to as "arithmetic attribution”, and is arithmetic in the sense that it describes the difference between the portfolio return and the benchmark return.

Conversely, the more intuitive geometric attribution explains the active return or alpha generated by the investment capability. One advantage of doing attribution in geometric form is that the attribution results translate consistently from one currency to another, and is theoretically sound for both single period and multi period analyses – without the need for smoothing.

I have left multi-factor analysis and style analysis out for the purposes of this discussion, as both are not widely accepted in the industry.

Of course, the limitations with both forms of attribution is that they are backwards looking, and rely on a pre-determined benchmark - which may not be appropriate or may drift over time. This makes it difficult to render effective comparisons between capabilities with different benchmarks, requiring an understanding of the characteristics of the portfolio at each point in time, to better attribute excess returns to skill. Put bluntly: you need to understand what you’re investing in.

A further example of attribution is referred to as risk attribution, which breaks down the total risk of a portfolio into smaller units, each of which corresponds to each of the individual securities, or each of the subsets of securities in the portfolio as noted in the table.

Sector	Portfolio Weight	Benchmark Weight	Portfolio Return	Benchmark Return	Asset Allocation	Stock Selection	Interaction	Attribution
Equities	90%	70%	5.00%	3.00%	0.12%	1.40%	0.40%	1.92%
Cash	10%	30%	1.00%	1.00%	0.28%	0.00%	0.00%	0.28%
Total	**100%**	**100%**	**4.60%**	**2.40%**	**0.40%**	**1.40%**	**0.40%**	**2.20%**

This helps to determine whether value has been added through controllable decisions around asset allocation, stock selection, country or sector tilts, currency exposures, industrial bias’s or some other way. When compared over multiple periods, it builds up a useful picture of when and how the Manager adds value, and whether their contribution will be relevant for future environments. Obviously, this form of attribution can be extended to capture duration, credit and yield curve exposures for the less glamourous fixed income capabilities (which the disciples of Modern Portfolio Theory dictate that portfolios must continue to have an exposure to).

Other forms of attribution include holdings-based attribution (calculated on a periodic basis using holdings data) and transactions-based attribution, which is calculated from holdings and transactions data. Both have challenges to implement, and are beyond the scope of this ramble.

The challenge for advice participants is not the gathering of the information, but the validity of the benchmarks with which to compare. These must be unambiguous, investable, measurable, appropriate, reflective of current investment opinions and specified in advance to be of any use. Benchmarks can be based on indexes such as the ASX200, S&P 500, the Barclays Capital Aggregate Bond Index, or peer groups. Increasingly, consumers are seeking attribution based on target returns (e.g., the risk-free rate, inflation plus, funding requirements).

Whilst there is plenty more that can be said about attribution, it should be an integral part of the investment decision-making and Manager selection process, helping to identify how and when various investment capabilities contribute excess return. All advisory participants should feel confident in requesting this information from the capabilities that they are reviewing, and cautious when the information is not forthcoming. You can’t manage what you can’t measure with consumers starting to demand evidence of how the industry has added value in exchange for their fees.

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