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SENIOR CONSULTANT
The Voice of the Investment Management Consultant

Investment Methodology, The Holy Grail Of Consulting

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In a bull market, 80% of winning clients is in developing an asset study, creating investment policy and strategy, and constructing a portfolio. In a bear market, 80% of keeping clients is the performance monitor and tactical asset allocation. The last half of this consulting process, focused on keeping clients, has become a lost art. In an 18-year bull market investment performance was taken for granted, and the actual returns realized left little room for complaint. Not so in today's unforgiving market environment, which significantly alters how one engages their professional investment and administrative counsel for an on-gong consulting fee.

ROWPYN HAS FOUND BY CREATING SIX-MONTH LAGGING INDICATORS, IT CAN REPOSITION AS LITTLE AS 20% OF A PORTFOLIO, . . AND GENERATE EXTRAORDINARY RESULTS

Investment management consulting has emerged as a mainstream phenomenon only in the past 10 years with the advent of advanced systems technology. Because much of the past decade was at the height of the longest bull market on record, the process we use reflects the times in which it emerged. The extraordinary value proposition of investment management consulting in addressing and managing a broad range of investment and administrative values, not possible in commission brokerage, was alone sufficient to win business. Yet, today, we are finding that though our consulting solution has all the correct structural and technical components required under ERISA and UPIA, the actual results realized are not what we would have hoped for. This is not because consulting has failed; it was because our process is incomplete. It is because of our disappointment in investment returns that investment management consulting will evolve into a more complete form. It is not a question of whether consulting works but how good we are at consulting.

The days are over when one can sell consulting or sell process or professional money management as a product, because the financial markets are no longer forgiving. In the recent past, one could create investment policy and construct a portfolio around a one-time asset allocation decision, selling consulting as an investment product, and the market would make the broker look brilliant. There was a time in the recent past when one could sell individually managed accounts as an investment product, outside of the context of multi-manager portfolio construction, and the market would make the broker look brilliant. It was inevitable that more time and effort would have to be devoted to on-going professional investment counsel and portfolio management because in a normalized environment, the financial markets would not have been as forgiving as they have been over the past 18 years. In a normalized environment, much of the work and most of the value-added would be realized in the on-going monitoring and management of each client's portfolio. It is process or what one does with investment products that adds value, not investment products. This is where one's on-going advisory fee is more than justified by the on-going counsel provided. We have forgotten that the monitoring of portfolio performance and the tactical portfolio investments are at the heart of the client relationship and investment management consulting.

Consulting is not a way to free up lots of spare time by annuitizing one's commission brokerage book, as it is popularly promoted. Consulting requires skill and tremendous on-going effort because unlike commission brokerage, when the sale is made, one's work is not over. It is just beginning. Each client's portfolio is not cast in concrete for 15-25 years, it must be continually monitored and periodic tactical adjustments must be made. This is why we earn our on-going consulting fee. This is why, at the higher end of the market, it is very difficult for the consultant to have the time or the resources to manage more than 200 client relationships. In fact, the skill of the consultant in monitoring performance and in providing on-going professional investment and administrative counsel, especially tactical adjustments, will increasingly be the skill set that the marketplace will most highly reward.

The science of portfolio management is about to gain parity with the science of portfolio construction. One of the most misunderstood aspects of portfolio construction is the Brinson Hood and Beebower (1986) and Brinson Hood and Singer (1991) studies that found 93.6% of portfolio returns are attributable to being in the right configuration of asset classes and investment management styles, and less than 5% of returns were

attributed to being in the right investment. This long-term strategic asset allocation thesis has become the cornerstone of portfolio construction. This, in concert, with Charles Ellis' work on investment policy has promulgated the thought that asset allocation was rigidly set for the long term without significant adjustment. Ellis observed "in investment management the real opportunity to achieve superior results is not in scrambling to outperform the market, but in establishing and adhering to appropriate investment policies over the long term that position the portfolio to benefit from riding the main long-term forces in the market. Investment policy wisely formulated by realistic, well-informed clients with a long-term perspective and clearly defined objectives, is the foundation upon which portfolios should be constructed and managed over time and through market cycles." More recently, Ibbottson and Kaplan (2001) have confirmed that 90% of the variability of investment returns across time was explained by asset allocation policy. However, when Ibbottson and Kaplan asked the question differently to determine how much the variation in returns among funds is explained by differences in asset allocation policy, Ibbottson and Kaplan found asset allocation policy only accounted for about 40% of the differences between two funds' performance. Asset allocation is clearly important ,but the good news is the old conventional strategic asset allocation is not so important that investors and consultants should ignore all other considerations in constructing portfolios.

The recent market downturn has taught us all that process just empowers us to address and manage a broad range of investment and administrative values, but investment methodology determines how good we are in managing the highly visible investment values that have the most economic impact on the investor. In a great market, we have been so focused on addressing and managing the broad range of values most important to the investor that investment methodology has not been a primary consideration. In a down market, investment methodology becomes central to both the client's and the consultant's success and moves to the forefront of importance, constituting an additional layer of sophistication that directly effects portfolio and client performance.

Investment Methodology Is The Holy Grail Of Investment Management Consulting

Firms like Frank Russell have built massive institutional advisory services businesses around investment methodology or around how adept they are in constructing multiple manager investment portfolios in a market neutral fashion which would approximate an index-based benchmark. They were among the first to articulate to their institutional clients that it is what one does with investment products – or process – that adds value, not the investment product itself. Frank Russell also established, by virtue of regulatory mandate, that it is always in the institution's best interest to engage an objective third party as expert investment and administrative counsel than to serve as one's own investment counsel.

Frank Russell pioneered investment management consulting. The global success of Frank Russell and their mystic is legendary within the financial services industry. In essence, Frank Russell is in the investment methodology business, and it is indeed true that a consultant is only as good as his/her investment methodology. Thus, the consultant's strength – their investment methodology – could also become their weakness. So, how does one ultimately compete with the Frank Russells of the world? If we can't beat them, should we join them?

The best thinking on investment methodology comes from the investment management consulting industry which must wrestle with asset allocation decisions daily. Bob Rowe and Bodie Pyndus, two top consultants at a major U.S. brokerage firm, have created an extraordinary investment methodology audited and confirmed by the University of Chicago's Graduate School of Business, Center for Research in Security Pricing. The RowPyn Equity Investment Rotation ("EIR") methodology has beaten the average S&P 500 return by an average of 1,300 basis points (13%, or 30.58% versus 17.39% for the S&P 500) over a 22-year test period (1978-1999), while capturing 147.6% of the market's upside and 61.54% of the market's downside. Moving beyond back tested results, RowPyn has 4½ years of audited results which have achieved a 26.44% return versus the S&P 500's 13.38%, Wilshire 3000's 12.23%, and Russell 3000's 12.78% returns.

A review of RowPyn's investment methodology can help you to formulate your thoughts on creating your own investment methodology. As you will see, this is not necessarily in the realm of a black box, but the RowPyn EIR methodology is science-based, confirmed and audited by a highly credible institution, and completes very favorably with the best institutional investment methodologies. The point is: By having a measurable investment methodology, RowPyn can successful compete in the $100+ million institutional market with proprietary methodology, personally articulated and delivered by its developers, as part of a broad range of custom consulting services specifically responsive to each client's needs. This high level, local service is very appealing, particularly if the investment methodology generates superior results, as RowPyn does.

Many large institutional investors view the popular "black box" multi-manager investment methodology offered by Frank Russell and others as becoming divorced from consulting services and becoming more of an investment product than value added consulting services. If the perception is that value-added, personalized service is being divorced from black box investment methodology offered by the Frank Russells of the world, then local consultants would be much more effective in delivering Frank Russell investment methodology than Frank Russell because of the high level of personal service they bundle with it. More importantly, if Frank Russell were to leverage through advisors and consultants as they plan, their market neutral investment methodology is open to far more scrutiny than in the past. This leaves the door wide open to other investment methodologies like RowPyn that go far beyond a market neutral investment mandate.

The technology of investment management consulting has, in fact, leveled the playing field. Today it is very likely that major institutional investors will find superior services, superior advice and superior results from local sources.

The RowPyn investment methodology is very appealing in its logic and extraordinary in its results. The RowPyn EIR methodology is based on six fundamental investment observations:


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1. Growth and value investment management styles are distinctly different investment methods with distinctly different results.
2. One style will have a higher return for an extended period of time, typically from one to five years.
3. Style dominance is over all stock capitalization sizes.
4. Style is a larger contributor (85%) to investment performance than skill (15%).
5. Diversification among all styles results in below-market returns.
6. Style and cap size adherent investment managers will typically:
   - deliver returns above their respective style and cap size index when their style and cap size is in favor; and
   - deliver sub-par returns versus their index when their style and cap size is out of favor.

Thus, the question asked by RowPyn is: Why would one want to invest in the underperforming (out of favor) investment management styles? Of course, if one knew the underperforming elements of the portfolio in advance, they wouldn't invest in those areas. Conventional wisdom has been that it is not possible to predict before the fact what elements of the market will underperform. But, what if we could determine after the fact what elements of the market were actually underperforming and which were overperforming? Would that underperformance or overperformance persist over a sufficiently long period of time to make that knowledge valuable in asset allocation decisions?

RowPyn has found by creating six-month lagging indicators, it can reposition as little as 20% of a portfolio, tilting it toward overperforming styles and away from underperformance, and can generate extraordinary results as previously cited. Over the past 10 years, RowPyn has created a 38-algorithm formula that signals under- and overperformance. This has been verified by a University of Chicago analysis in only the second such research letter they have issued in the past 15 years. The RowPyn EIR model provides extraordinary insight into making better investment decisions, because management styles tend to be in favor for periods of one year or longer. But more importantly, because research has shown institutional investors are highly influenced by prior 1-3 year investment performance in making investment decisions, RowPyn EIR can be extremely valuable in avoiding poor investment decisions. The RowPyn EIR model has a 26-factor regression analysis that can determine when a management style is beginning to erode, which alerts the investor to impending changes in management style or cap size leadership, thereby avoiding poorly timed investment changes, as often occurs in the extrapolation of performance. It is important to note that RowPyn EIR does not employ market timing strategy; all portfolios following this methodology remain fully invested through all market cycles.

With advanced investment and systems technology and more sophisticated investment methodologies, we are no longer at the mercy of market neutral strategies where we just hope to come close to beating the index or where we are assured a large portion of our portfolio will underperform. The historical performance characteristics of asset classes are an invaluable tool in portfolio construction, especially when there is a long institutional time horizon of 20-30 years, or in the case of foundations, even 50 years. But because individual investors have a much shorter time horizon and are much more sensitive to market swings, leading consultants have been forced to develop far more time-sensitive investment strategies that rely on shorter term information. By firms like RowPyn creating investment methodologies that do not predict or guess, but react to actual market movement, we gain innovative, new ways to help investors achieve better risk-adjusted results. By extension, the institutional market is profoundly affected by better information for better decisions and better results. Thus, investment methodology truly becomes the Holy Grail of investment management consulting. Whether one is an institution or individual, the actual investment performance realized ultimately determines how well advised we are.

Choosing an investment methodology will become the ultimate consideration in building a consulting practice because it clarifies and delineates the value the consultant adds in the context of the broad range of investment and administrative values the consultant addresses and manages. Investment methodology determines how good we are at adding value, which, in a difficult market, is welcomed by both the consultant and their clients. We can no longer rely on the equity markets to make us look good. If we are accountable and assume responsibility for our professional investment and administrative counsel, in addition to being able to speak hours on the investment process we use to address and manage the investment and administrative values necessary for the client to achieve their goals and objectives, we also must be able to speak hours on our investment methodology that determines how good we are in adding value. Thus, investment methodology is, indeed, the Holy Grail of investment management consulting. ■

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