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SENIOR CONSULTANT
The Voice of the Investment Management Consultant

Investment Methodology Revisited: The Holy Grail of Consulting

by Stephen C. Winks

Editors note: "Investment Methodology, The Holy Grail of Consulting" first appeared in our September 2001 issue of SENIOR CONSULTANT and has been downloaded several hundred thousand times, making it one of our most read articles. In today's flat or low investment return environment, investment methodology becomes as important today as it was in the depths of a three-year market downturn. Importantly, the EIR investment methodology we use as an illustration now has an eight year track record and is commercially available for the first time, so it is not only an ideal time up update our discussion on investment methodology but today you can actually avail yourself to an investment methodology that competes very favorably with market neutral strategies.

In a bull market, 80% of winning clients is reviewing their holdings, creating investment policy and strategy and constructing a portfolio, the market does the rest. In a bear or low return market (like today), 80% of keeping a client is the performance monitor and tactical asset allocation. The last half of this equation, focused on keeping clients, has become a lost art. In a prolonged bull market of the 90's investment performance was taken for granted, the actual returns realized left little room for complaint. Not so in today's less than forgiving market which significantly alters how we engage our counsel.

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

There aren't any books on how to make the markets go up, but there is wise counsel on what to do when the markets are not going your way. Investment management consulting has only emerged as a mainstream phenomenon in the past 15 years. Because much of the past 15 years 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 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, in a flat low return environment the actual results achieved are not what we would have hoped for. This is not because consulting failed, it is because our investment process is incomplete. It is because of our disappointment in investment returns that investment management consulting will evolve in a more complete form. It is not a question of whether consulting works but a question of how good we are at consulting.

The days are over when one can sell consulting or professional money management as a product with no ongoing counsel, because the financial markets are not always 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 advisor 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 advisor 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 in the 90's. 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 in and of themselves.

This is where one's on-going advisory fee is more than justified by the on-going counsel we provide. We have forgotten that the monitoring of portfolio performance and the continuous comprehensive counsel (tactical asset allocation) required to fulfill our fiduciary responsibilities is 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 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 case in concrete for 15 to 20 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 that 200 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 catch up with the science of portfolio construction. One of the most misunderstood aspects of portfolio construction is the Brinson, Hood and Beebower (1986) and the 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 rigidily 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 policies 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 Ibbotson 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 amoung 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 fund's performance. Asset allocation is clearly important, but the good news is strategic asset allocation is not so important that investors and consultants should ignore all other considerations in constructing portfolios.

WHEN IBBOTSON AND KAPLAN (2001) ASKED THE QUESTION DIFFERENTLY, THEY FOUND ASSET ALLOCATION POLICY ACCOUNTED FOR ABOUT 40% OF THE DIFFERENCE IN PERFORMANCE, NOT THE 93.6% MORE OFTEN CITED.

The 90's and a three year market down market have taught us that process (asset/liability study, investment policy, strategic asset allocation, manager search and selection, performance monitor, tactical asset allocation) just empowers us to address and manage a broad range of investment and administrative values as required by regulatory mandate, 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 investment and administrative values most important to the investor that investment methodology has not been a primary consideration. In a down or low return 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 how adept they are in constructing multiple manager investment portfolios in a market neutral fashion that would approximate market indices, as a performance benchmark. They were amoung 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 institutions best interests 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, as it must wrestle with investment decisions daily. Bob Rowe and Bodie Pyndus, two top industry consultants have created an extraordinary investment methodology, Equity Investment Rotation (EIR), which has been audited and confirmed by the University of Chicago's Graduate School of Business, Center for Research in Security Pricing. EIR defies the conventional wisdom of a market neutral strategy that maintains it is not possible to beat the market. EIR has consistently outperformed the S&P 500. It makes a compelling case that a disciplined investment strategy which by design continuously and comprehensively monitors account holdings, can consistently out perform and out perform by a good margin. EIR has annualized audited eight-year returns of 16.68% versus 7.98% for the S&P 500, with a beta of 1.01. This translates into 70% more return with the same risk as the S&P 500. Thus your fate need not be tied to the index.

EIR HAS BEEN VERIFIED AND VALIDATED BY THE UNIVERSITY OF CHICAGO CENTER FOR RESEARCH AND SECURITY PRICING. OVER THE PAST EIGHT YEARS EIR HAS BEATEN THE MARKET BY ABOUT 70% WITH ABOUT THE SAME RISK AS THE MARKET.

A review of EIR'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 the black box, but EIR is science based, confirmed and audited by a highly credible institution and competes very favorably with the best institutional investment methodologies. The point is: by gaining access to a proven investment methodology like EIR, you can successfully compete in the HNW and institutional market with what is now your proprietary investment methodology, confidently articulated and delivered by you. EIR is just part of a broad range of custom consulting services specifically responsive to each of your client's needs. This high level, local service is very appealing, particularly if the investment methodology out performs. By being local you have the advantage in building local relationships, you can be far more effective in delivering your investment process than your big out of state institutional competitors. You can better pick up on your client's needs, better collaborate with local legal and accounting professionals and better educate the client, going deeper and broader in more relevant ways. By your investment methodology out performing your larger competitor's market neutral strategy, you have everything you need to win the confidence of large middle market clients and to build a very large advisory services practice. Though your prudent investment process is important in fulfilling your fiduciary responsibilities, your investment methodology determines how good you are as a consultant in the client's mind as you are literally adding value.

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 far more effective in delivering the Frank Russell investment methodology than Frank Russell because of the high level of personalized service the local consultant brings. More importantly, if Frank Russell were to leverage through third party advisors and consultants as they plan through Schwab and Fidelity, their market neutral strategy will be open to far more scrutiny than in the past. This leaves the door wide open to other investment methodologies like EIR that can 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 large institutional investors will find superior services, superior advice and superior results from local sources.

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

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 five years or more.

3. Style dominance is over all stock capitalizations.

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 sup-par returns versus their index when their style and cap size is out of favor.

Thus, the question asked by EIR 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 under-perform. But what if we could determine after the fact what elements of the market were actually underperforming or outperforming? Would that under-performance or out-performance persist over a sufficiently long period of time to make that knowledge valuable in asset allocation decisions?

RIR has found by creating six-month lagging indicators, it can reposition as little

as 20% of a portfolio, tilting it toward outperforming styles and away from underperforming styles, it can generate extraordinary results as previously cited. EIR has a 38-algorithm formula that signals under and over performance. This methodology has been verified by University of Chicago analysis in only the second such research letter issued in 15 years. EIR 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 to 3 year investment performance in making investment decisions, EIR is extremely valuable in avoiding poor investment decisions. EIR also 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 and cap size leadership, thereby avoiding poorly timed investments which often occurs when one presumes the extrapolation of performance. It is important to note by using better information, EIR is not market timing, it is always fully invested over all market cycles, and only makes slight incremental adjustments in the portfolio over the course of a year, entailing only 20% of the portfolio. EIR is essentially very dynamic strategic asset allocation based on very careful evaluation of actual market movement not speculation.

With advanced diagnostic tools, modern 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 the portfolio will under-perform. The historical performance characteristics of asset classes are an invaluable tool in portfolio construction, especially when there is a long institutional time horizon of 30 to 50 years, or in the case of foundations and endowments, 100 or more years. But because individual investors have a much shorter time horizon and are much more sensitive to market swings, consultants are forced to developed far more time sensitive investment strategies that rely on shorter term information. By investment methodologies like EIR which do not predict or guess, but rely on reacting to actual market movement, we gain innovative new ways to help investors achieve better risk adjusted returns. 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 an individual, the actual investment performance realized ultimately determines how well we are advised.

Choosing an investment methodology will become the ultimate consideration in building a consulting practice because it clarifies and delineates the value the consult adds in the context of the broad range of investment and administrative values the consultant addresses and manages. Invest methodology determines how good we are at adding value, which in a difficult market is welcome 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 our investment process through which we fulfill our fiduciary responsibilities, we must be able to speak hours on our investment methodology that determines how good we are at adding value. Thus, investment methodology is indeed, the holy grail of investment management consulting. ■

Notes

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