An occasional paper from Fiscal Engineers

A 'set-and-forget' investment approach? Forget it!

Summary

Systematic, evidence-based investing often results in very little activity in a portfolio. It is wrong to think that this is the result of a ‘set-and-forget’ strategy. The Firm’s Investment Committee would be aggrieved at such a suggestion! Considerable effort goes on behind the scenes to allow this state of calm consistency to exist. The fortitude and discipline to deliver ‘not much needs to be done to your portfolio except for rebalancing’ advice, comes from a rigorous process of ongoing challenge to the status quo. This note provides an insight into the furious paddling below the surface, belying the calmness above the water.

A ‘set-and-forget’ investment approach? Forget it!

“Be a duck, remain calm on the surface and paddle like hell underneath.”

Michael Caine, actor

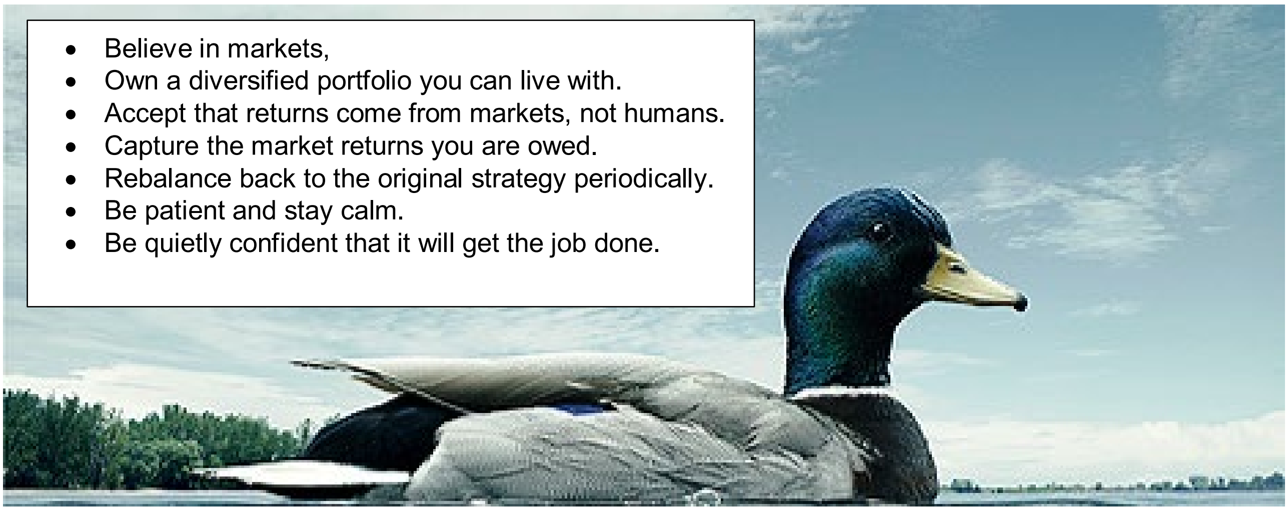
You don’t have to look busy to provide good advice

In most walks of life when you employ a professional or craftsman, you expect a little bit of action for your money. Now is generally better than later, and more is generally better than less. However, this generality does not apply in some areas. Take the case of a GP, for example, where a patient comes into the surgery with a very sore throat and flu-like symptoms. Today, many GPs feel under increasing pressure from patients to come up with some ‘scientific’ solution – such as the prescription of antibiotics – to their ailments and some patients almost feel cheated when the advice they receive is simply to swallow a couple of paracetamol tablets and to take it easy for a day or two. Do we doubt the training, experience and wisdom of the GP because of the advice we receive? Hopefully not; after all science tells us that antibiotics don’t work on viruses, only bacteria. The same pressures apply to advisers like us when it comes to investing. Adopting an evidence-driven, systematic approach to investing can feel as if a portfolio, once set up, is just left to roll on in a ‘set-and-forget’ manner.

Every time you open your valuation statement outlining your portfolio, it is likely to look largely unchanged, both in terms of its structure and the products through which the investment strategy is implemented in practice. One of these products is likely to catch your eye as it has not done as well as the others, or the portfolio as a whole is down and it might be tempting to ask, ‘what are you going to do about it?’ The answer is probably going to be ‘Nothing!’ In this short note we want to focus in on what goes on behind the scenes, within the Firm’s Investment Committee, that inform us that ‘Nothing!’ is usually – but not always – the right answer!

As an existing client, you will now be familiar with us telling you: to stay calm at times of market jitters; that we will rebalance your portfolio on a regular basis; that returns come from the markets; that costs really matter; that a sensible long-term, diversified portfolio structure is key and; to avoid looking at your portfolio too often!

Figure 1: Systematic investing – the view from a client’s perspective



The most crucial message to take away from this note is that we advise all of these things, not because they are easy for us – they are not, as we will explore below – but that is what the evidence suggests gives you the greatest chance of experiencing a good investment outcome.

Challenging the status quo

The seeming lack of investment activity on a portfolio from one period to the next, belies the considerable time, effort, discipline and fortitude that goes into achieving this for our clients. The Firm's Investment Committee sits at the heart of this effort and one central question drives its efforts: does the investment approach adopted still represent best practice, based on the latest evidence and theory available to us? That is a big question, which takes quite a lot of answering and there are many layers to it. One risk to any thesis is that of confirmation bias, which is where one selects evidence that fits – rather than challenges – the thesis. An important point to note is that the overriding goal of the Firm is to do what is in a client's best interests, not to defend systematic, evidence-based investing as the only way to invest money, now and forevermore. The Investment Committee is always open to challenge of the status quo. That said, the evidence is highly compelling and any changes down the line are likely to be evolutionary, rather than revolutionary.

Behind the scenes, the Investment Committee is paddling away furiously to make sure that client portfolios remain robustly structured and the long-term strategy is executed using best-in-class products and that the ongoing oversight is both regular and robust. Risks and opportunities on the horizon are keenly observed.

Figure 2: Systematic investing - the view from the Investment Committee's perspective

The broad terms of reference of the Investment Committee are set out below:

Manage risks over time

- The Investment Committee is responsible for the oversight of the risk in portfolios and the wider investment process. Meetings are regular and minutes are taken, which include all action points to be followed up on. Third-party inputs and guest members – such as Albion – provide independent insight and challenge.

Challenge 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 our clients' best interests, then we will revise our approach. The investment process is evolutionary, but change is most likely to be slow and incremental.

Review the portfolio structure

- The underlying characteristics of the Firm's client portfolios are reviewed, including performance and risk level attributes. Risks (asset class exposures) and their allocations within a portfolio are evaluated. Any issues are raised and resolved. Existing asset classes are reviewed alongside asset classes and risk factors that currently sit outside the portfolios. Areas of interest are placed on a longer-term 'watch' list.

Review the incumbent 'best-in-class' investment products

- The incumbent products are 'best-in-class' choices seeking to deliver the returns due to investors for taking specific market risks. Each product has a role to play in a portfolio and its ability to deliver against this objective is regularly reviewed. Any product-related issues are raised and resolved.

Screen for new products and undertake appropriate due diligence

- Although the incumbent products were recommended as 'best-in-class', new products are regularly being launched. Tough screening criteria are in place against which new funds are judged. New, potential 'best-in-class' products face detailed due diligence and approval. They are included only when they make the grade. Given the quality of the products already in portfolios, the threshold for replacement is high, but not insurmountable for newer products.

Reaffirm or revise the investment process

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

What might the future hold?

As part of the ongoing process of challenge, there are a number of topics around which much thinking, discussion and ultimately decisions are required. Here are several:

- China has recently allowed its 'A' shares i.e. domestic shares listed on bourses in China to be accessed more widely and they are being increasingly included by index providers in their indices, albeit from a low base. Currently China represents around 30% of the emerging market allocation (that is only 3% or so of global market capitalisation in total), but this could grow materially in the coming years as its capital markets grow as more companies are listed and more of each company's equity is freely traded. At what point does the allocation in a) the emerging market and b) the world index need review and possible action, as China is, after all still a totalitarian state?
- The Firm adopts a risk-factor framework for constructing portfolio i.e. it makes allocations predominantly to market, value and size risk factors on the equity side and duration and credit on the bond side. Interesting risk factors such as momentum, betting-against-beta and strategies such as trend following are currently prominent in the academic literature. What threshold would a factor need to exceed before it should be considered for inclusion in a portfolio? What would an integrated strategy look like to include an additional factor in a portfolio, given the interrelationship with existing factors already used? What does a 'best-in-class' product look like in this space?
- The US represents around 60% of developed market capitalisation, yet it produces around 25% of global GDP despite representing only 7% of the world's population. Does a point get reached, if the US were to continue to outperform other markets, where the concentration in one market, despite its global companies, continues to make sense?

One can perhaps see that whilst none of these issues are immediately pressing – and should certainly not be rushed into in a vainglorious attempt to be ahead of the curve – it is perhaps easy to see that the Investment Committee has some interesting and taxing decisions ahead of it in the coming years, that may – or may not – slowly weave their way into your portfolio.

Independent, third-party support in the process

The Firm has engaged the services of Albion Strategic Consulting to provide third-party, independent input into the Investment Committee, sitting as a guest member. It provides ongoing research on investment matters, reviewing the latest evidence supporting or challenging our approach and its findings are reviewed in the meetings. It produces its research reviews – Albion Governance Update – twice a year. In addition, it provides a 'Portfolio Analysis' dashboard, which provides considerable insight into the behaviour of both the products used in constructing portfolios and the aggregated portfolios themselves. Albion's Risk Matrix monitors regulatory, investment process and market risks faced by the Firm. These inputs provide useful analysis for the Investment Committee to review, discuss and raise any pertinent issues.

Figure 3: Inputs into the governance process

It's sometimes hard to do nothing, but it's usually the right thing to do.

Investment theory, academic research and empirical evidence, robust primary thinking and a good dose of common sense provide the foundations for the fortitude and discipline required to run a long-term, strategic and systematic approach to investing. Without this deep certainty and quiet confidence, the noise, excitement and sometimes pain faced by investors can result in too much action, much of it inevitably of the knee-jerk, emotional variety.

It takes fortitude and discipline to stay calm at times of market crisis, to remain invested and to rebalance the portfolio, if necessary. It takes fortitude and discipline not to chase 'hot' parts of the markets (bitcoin, gold, tech stocks, China etc.) or 'hot' managers (e.g. Fundsmith), or to restructure the portfolio to take advantage of or avoid short-term opportunities and challenges (Brexit, China trade wars, low yields on high quality bonds) or giving up on certain parts of the diversified portfolio that happen to be suffering at present (value stocks and emerging markets). It takes fortitude and discipline to keep meeting with clients and to tell them again that, despite the fees they pay (remembering though that most of the fee relates to the financial planning work and advice they receive rather than investment management), their portfolio does not need changing.

The next time you open you latest valuation report, remember that despite the lack of activity on the surface, the Investment Committee continues to paddle furiously behind the scenes to allow this be the case. In the immortal words of the investment legend and author Charles Ellis:

'In investing, activity is almost always in surplus.'

Perhaps we should amend this slightly to:

'In investing, activity is – except for the Investment Committee – almost always in surplus.'

The Team at Fiscal Engineers

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Other notes and risk warnings

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