FOCUS CONSULTING GROUP

INVESTMENT PROCESS REVIEW

James W. Ware, CFA

This document describes our approach to a thorough review of a firm's investment process. Read it carefully and consider your answers to the questions posed.

Purpose

To examine and agree on the investment philosophy and process that will best serve the firm.

Method

1. Read and review this document as a way to prepare for the discussion
2. Distribute any other firm material that will help frame the discussion or provide necessary information
3. Select the appropriate participants from the firm
4. Schedule 30 minute phone interviews with each participant (optional)
5. Pre-work: draw a picture of the investment process, including these elements:
   a) Data collection, screening, and idea generation
   b) Research and Analysis
   c) Decision making on securities
   d) Portfolio construction and risk
   e) Performance attribution/Evaluation
6. Feedback on how the process is working
   a) Determine groundrules for the discussion. We recommend:
   b) Choosing curiosity over defensiveness
   c) Choosing candor over withholding
   d) Choosing responsibility over blame

Overall Goal

What are you trying to achieve? How will you know if you've done it?

1. What is the purpose of this portfolio?
2. Who are you competing against?
3. How is success measured? What are the relevant benchmarks?
4. How is risk accounted for?
5. What does success look like in 5 years? Paint the vision of success.

What follows is a discussion of investment philosophy. Investment philosophy addresses the beliefs that underlie the process. It answers the questions, "why do we think we can add value? Where are the opportunities?"

In contrast, investment process addresses the strategy for implementing the philosophy. It answer the question, "how can we implement the philosophy? How do we operationalize it?"

The Role Of Investment Philosophy

Investment philosophy plays a critical role in creating a winning performance record, while also serving as an excellent marketing tool. Despite the dual benefit of having a logical and compelling philosophy, most managers that we encounter do not articulate one. Instead we find statements that are more often marketing slogans or product positioning statements. In what follows we suggest strategies for creating a compelling investment philosophy.

What Is An Investment Philosophy?

If investing were an exact science, there would be no need for a philosophy. Instead, we could just calculate the exact intrinsic value of any cash flow and say - voila - that is the correct price of the asset. In practice, we cannot predict all the necessary ingredients of the discounted cash flow model, so we need to make some assumptions. Once assumptions enter the picture, we are in the land of philosophy, where we must justify why we have chosen certain assumptions. Let's define *investment philosophy* as follows:

- A set of beliefs regarding the security pricing mechanism and what it is about that mechanism that sometimes causes securities to be mispriced;
- A set of beliefs regarding the manager's competitive advantage in exploiting these mispricings;
- A thesis about how these beliefs can be exploited to generate alpha (an "alpha thesis").

We might go further and define a sound investment philosophy as one that:

- Knows where it stands with respect to capital market theory and evidence.
- Is living; that is, it wrestles with confirmation and disconfirmation as it is used in practice, and adapts as necessary.
- Has deep enough core principles that adaptation does not result in total change.

How Does Investment Philosophy Support Superior Results?

Although no studies have linked investment philosophy to superior returns, it seems safe to say that the team with a logical and compelling philosophy will outperform one with an illogical or inconsistent approach. (If the reverse were true, investing would become the new "dismal science"!)

Investment teams that create investment philosophies with the following attributes tend to win in the markets:

1. *Have a clear thesis of how they generate alpha.*
   Managers are not likely to generate ex-ante alpha without having a very clear idea of what they do that generates alpha, what it is about the markets they invest in that provides the opportunity to generate alpha, and what their competitive advantage is in exploiting that opportunity.
2. *Put significant effort into understanding where their performance comes from.*
   Good managers recognize that they have as much at stake as anybody in understanding whether their performance is due to successful execution of the alpha thesis, benchmark misfit, or luck, and are therefore very thoughtful about evaluating their own performance.
3. *Have thought about whether their alpha-generation process will need to change over time.*
   In competitive capital markets, alpha-generation sources tend to be arbitraged away. Good managers understand this, and therefore monitor whether or not it is happening, and have a process for seeking out new alpha sources which lever the manager's competitive advantage.

Based on the above, we suggest that each investment firm subject itself to an "investment philosophy test":

What is the thesis (or theses) for how the product generates alpha?

- What is the conceptual basis of the alpha thesis?
- What is the relationship of this view to capital market theory?
- What is the manager's view about the security pricing mechanism that underlies the thesis?
- What is the manager's competitive advantage in executing the thesis?
- What is the evidence that alpha has been generated by successful execution of the alpha thesis and not a mismatched benchmark or luck? If evidence is lacking, how does the manager convince him- or herself that the thesis is sound?
- How does the manager think about the possible need for the alpha thesis to change over time?

Astute clients will ask these questions, perhaps not in this language, so it pays to have a thoughtful answer to each of them.

Common Ways Of Failing The Investment Philosophy Test

The majority of investment teams that we work with do not pass the investment philosophy test. The following are examples of common failings:

1. *Managers that don't have an alpha thesis.*
   Many firms simply accept a common process for security selection (doing fundamental research and choosing "cheap stocks") without giving careful thought as to why their firm will win at this very difficult challenge. If the firm has a strong track record, we can often tease out the reason why they have added value. Sometimes the best we can come up with is that their PM has a gift for picking securities. (i.e. Warren Buffett, Bill Miller, Bill Gross, Peter Lynch)
2. *Managers that have an alpha thesis that isn't conceptually grounded.*
   Many firms offer an explanation for value-added by stating that their approach has always worked (e.g., low P/E stocks). Evidence of past success is not sufficient to explain why a strategy should work in the future. David Dreman is a good example of a successful practitioner who has thoroughly explored the low P/E strategy and why it should work—even into the future.
3. *Managers that don't think very deeply about where their performance comes from.*
   Firms that have established good performance records often cannot articulate what accounts for the performance. They are happy and relieved to have the strong track record and leave it at that. We suggest that they get curious about the source of their performance; clients will be! This is especially true if firms go outside of their selection universe when choosing securities.
4. *Managers that don't think about whether their alpha generation process is based on temporary characteristics of the markets.*
   Firms that enjoy short term success by following trends often ignore the more challenging questions about their approach, like: Why do these securities trend? Might the underlying cause of trending change over time? How do you monitor whether or not the underlying cause is still present? Why do your trading rules work? Why are they not arbitraged away?

Often investment teams simply seem unwilling to reflect carefully on these sorts of questions.

Helping Firms Articulate Their Alpha Thesis

Few investment teams have good answers to all the questions, so much of our work involves exploring with them the reasons for their success (or lack of it.) One key to this process is to ask the investment leader and his/her team tell their investment story. We then listen intently to hear the beliefs and assumptions that are buried in the process. We can then discover the team's game plan for adding value.

Some of the discoveries of best practices using this process are as follows:

1. *Managers that measure the success of the steps of the process and not just the ultimate outcome.*
   For example, consider a bond manager that makes the claim that his or her credit research not only predicts upgrades and downgrades, but makes those predictions before the expectation of a rating change is reflected in the market price. This manager tracks every prediction to see if the market consensus (as reflected by price) and rating agencies come around to his or her view. I get comfort from the facts that
   (a) such managers know their views only have value if they are not only correct but different than consensus; and,
   (b) they track how prices eventually come to reflect, or not reflect, their views. Similarly, managers that evaluate their own performance with strategy benchmarks designed to replicate their selection universe demonstrate they understand the importance of attempting to differentiate alpha from noise (Kuenzi, 2003).

2. *Managers that recognize that every strategy they come up with is potentially subject to being arbitraged away.*
   For example, consider a quantitative equity manager that that plays many themes at once. Each theme is viewed as having a finite life, and the performance of each theme is isolated and monitored so as to observe the decay in the value of the theme. The manager considers his or her competitive advantage to be in the identification of new themes, and in the technology for measuring the contribution of each theme to performance. A similar idea is presented in the adaptive market hypothesis of Lo (2001), where the market is always tending toward efficiency, but the types of trades needed to move it towards efficiency rotate and evolve over time.

3. *Managers that claim they exploit inefficiencies, and identify the specific inefficiency they are exploiting with every position they take.*
   Most managers that say they exploit inefficiencies use this claim as a broad justification for their investment process, but are unable to identify the specific inefficiency they are exploiting in any given decision they make. Those that routinely specify how their information or point of point differs from that reflected in price are much more credible.

4. *Managers that know their companies so well that they are quicker to interpret change, even though they have no explicit alpha thesis.*

There is always an exception to the rule. Sometimes a manager is simply talented and cannot articulate an alpha thesis. Despite examples such as these, it remains frustratingly difficult to distinguish between true alpha-generators and alpha-pretenders. I believe there is more that alpha generators can do to distinguish themselves, and that clients should be more insistent that they do it.

Conclusion

Passing the Investment Philosophy test is not easy, as evidenced by how few firms have a convincing statement. Firms do, however, improve their chances for creating real alpha and for telling a more convincing story to clients and consultants if they work to create a logical and compelling investment philosophy.

This article is adapted from:

Minihan, J. (2006). The role of investment philosophy in evaluating investment managers. *Journal Of Investing, Summer*.

Appendix: Worksheet for Investment Process Review

Core Investment Beliefs & Philosophy (What do you believe is true about markets?)

1. Describe the investment philosophy. Is it active or passive? Question: Why do market opportunities present themselves? (that is, how is it possible to earn excess returns?

2. What are the basic beliefs that you hold about markets and investing? Examples:
   a. You believe that markets are largely efficient but periodically there will be a clear example of mispricing which warrants action.
   b. You believe that you can win in the markets because analysts know their companies better than nearly anyone else.
   c. You believe that intuition is largely responsible for excellent performance vs. detailed and extensive fact finding. Is value added more art than science?
   d. You believe in experts vs. the wisdom of crowds?
   e. You believe in team decisions vs. a "star" portfolio manager
   f. You believe that "diversity" trumps "ability" (see Scott Paige, "The Difference")

3. Based on your beliefs, where can you add value?
   a. Individual securities selection
   b. Sector weightings
   c. Country selection
   d. Currency
   e. Market Timing
   f. Multiple sources of value added or focus on a primary source and neutralize the others
   g. Other

Structure and Strategies (How do you win? What is your edge?)

4. What is the structure of the team: analysts and PM's? Is each one a separate career path? Or do analysts all aspire to be PM's?

5. Who has decision rights in the selection of securities: one PM, several PM's, a committee? (PM decides, PM decides with input, Majority vote of investment committee, consensus of investment committee).

6. Where do investment ideas come from? (Is there an approved list? Is there a screening process? From PM's or street analysts?)

7. Do analysts follow industries or are they generalists?

8. What are the key questions that every analyst/PM must answer about any recommended stock/bond?

14. What is the level of diligence required for each piece of research?

15. Are written reports required? How long? What must they include?

16. What is the time horizon for an investment? Who determines it?

17. Must our process be uniform across all sectors or does each sector have different key drivers? Do you advocate trial balloons? (i.e., testing an idea before spending too much time on it?)

18. When in the process is a written report required?

19. Do you have a peer review process? How does it work?

20. Do you have a "devil's advocate" process? (One person is selected to challenge a given holding)

21. How much external support is necessary in recommending a stock/bond: visiting the management, talking to management, talking to a street analyst?

22. Describe the valuation tools that you use: DDM, momentum tools, low P/E, low P/BV, technical, etc.

23. Do you have strict rules regarding valuation targets for new purchases?

24. Do you calculate target prices for each holding versus a calculation of intrinsic value?

25. What methodology do you use to calculate intrinsic value?

26. To what degree are you looking for catalysts in undervalued securities?

27. How do your holdings deviate from the benchmark?

28. What are the strengths or the current investment process? The weaknesses?

29. Do you slowly average into and out of positions or do you move quickly?

30. Is the sell decision decision the flip of the buy decision or are there differences?

31. Is the decision making authority the same for buy and sell decisions? Is it easier or quicker to make and implement sell decisions?

32. Are all portfolios alike or are there variances around a model portfolio?

33. What is your investment horizon? Is it the same for all sectors and asset classes?

Professional Staff (Whom do you hire? What do you look for in analysts/PM's?)

34. What is the hiring process for new professionals? How do you get the best talent?

35. What are the attributes of your best analysts? PMs?

36. Have you measured them using Myers-Briggs, Enneagram, DiSC, Kiersey Temperaments, etc.?

37. Have the analysts identified their areas of greatest competence? (e.g. some analysts are good at gathering facts, some at interpreting them, others at making decisions: buy/sell.)

38. How much time are the investment professionals focused on their areas of competence? (Top firms have professionals aligned with their areas of competence and spending 80% of their time in this area.)

39. Do you have a strategy for supporting analysts or PM's who are in a slump? What is it?

40. Which behavioral finance (e.g. anchoring, overconfidence, etc.) mistakes are you most prone to making? How do you guard against them?

41. What communication is expected of PM's? Analysts? To whom? How often?

42. Is your process people-centric? (dependent mostly on the talent and brains of staff) or process-centric? (dependent on a highly defined and disciplined process)

43. Do you hire people with experience or do you prefer to train your own people?

44. Do you prefer investment education and experience or do you prefer people with broad and divergent backgrounds and experiences?

Compensation and Incentives (How do you reward your staff?)

45. How are PM's and analysts currently incented? What behaviors and outcomes are encouraged?

46. Is incentive compensation based on team or individual success?

47. Is incentive compensation paid out over extended periods as a way of encouraging long-term employment?

48. How is success measured for PM's? For analysts?

49. What are the non-monetary rewards that you offer?

Resources and Development of Talent (How do you continually improve?)

50. Which books are "required reading" in your firm? Which magazines, periodicals?

51. Which investors do you admire? Which other investment firms?

52. Which conferences do you encourage your staff to attend (CFA sponsored, etc.)?

53. Which degrees do you encourage/demand that your staff acquire (CFA, MBA)?

54. Describe what role coaching or mentoring takes at your firm?

55. How do you develop your leaders? Your professional staff?

56. Do you have a formal succession process? Describe it.

Data Collection and Screening

57. Describe the process for collecting data and screening it?

58. Do analysts visit companies?

59. Do you consider collection and screening as a competitive edge?

Research and Analysis

60. Once the data is collected, describe the research and analysis activities.

61. What resources are mainly used for reaching investment decisions (sell side analysts, company sources, etc.)?

62. Is the analysis of investment data one of the competitive advantages in your process?

Security Selection

63. Describe the decision making process for selecting securities (who makes the decision? One person, a group, a committee?)

64. Does decision making vary from one portfolio to another?

65. Are different names owned in portfolios, or is there an emphasis on "our best thinking" portfolio?

66. What is the sell discipline?

Portfolio Construction and Risk

67. Describe the process for building portfolios.

68. Describe the risk management process.

Performance Attribution and Quality Control

69. Describe how performance is measured and attributed

70. What quality control measures do you use?

Feedback for PM's and Analysts

71. Do you perform Post Mortems on investment decisions? (Why they worked? Why they failed?)

72. How often do you provide feedback to team members about their performance?