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WEALTH

Against the Gods

Lessons from the first 5 years of Multi-Asset Portfolios - Part II

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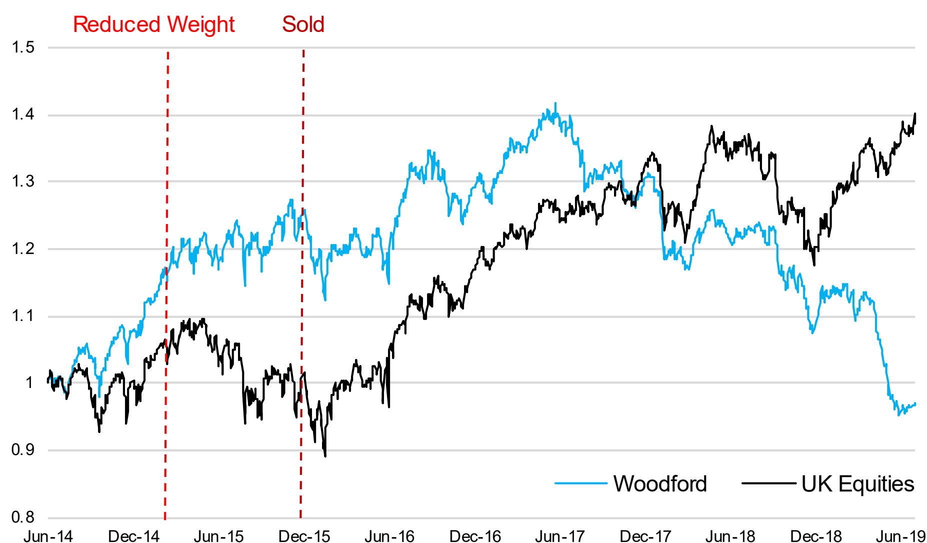
Part 2: Process over Outcome

"No man ever steps in the same river twice, for it is not the same river and he is not the same man."
Heraclitus

Building on the foundation of cost, what are the other important considerations for building a multi-asset portfolio? The most obvious is expected returns. However, predicting returns is notoriously difficult, especially when allocating to external managers. Returns are generated by portfolios, which themselves are generated through an investment process and data. What portfolio is being held at any point in time depends on ever changing market data and how the process interprets that data. Predicting the future of markets is difficult enough, but when investing in strategies with a discretionary approach (e.g. where the way that data is interpreted is mostly through human judgement), the process is also changing over time. Investors must deal with two layers of uncertainty – not knowing how the market will behave in the future and being equally uncertain of how the portfolio will have changed given that future.

In an interview with Paul Tudor Jones in 2016, Stan Druckenmiller (of Soros Fund Management fame) was asked about his investment process. Yet he himself didn't know how to describe the intricacies that went into his past decision making (let alone how he might choose to react in a future scenario). The human brain is the most complex and opaque black box on the planet. A discretionary investment process changes as often as the mood of the manager, which can lead to portfolios that change for purely behavioural reasons, independently of changes in the market environment. Past performance is never indicative of future returns (which is always unpredictable for any approach) – and in the case of discretionary managers it can be counterproductive for forming expectations. We have experienced many examples of this over the years, one being a well-known UK equity fund manager who has recently been making the headlines.



"…if you can meet with triumph and disaster, and treat those two impostors just the same"
Rudyard Kipling

Neil Woodford (CBE) has been a darling of the UK retail fund space for decades. Despite his recent difficulties, Woodford still boasts an incredible track record over a 30-year career, one of a number of reasons which led us to have exposure with him many years ago (both whilst he was at his previous firm and subsequently when he left to start out on his own in 2014). An important caveat up front - we don't believe we have any ability to time entry and exits into specific strategies. And though we got lucky with the exact timing of our exit in this instance, gains and losses from timing will be noise that washes out over the long term.

This case highlights the problem of being overly focused on outcomes in investment due diligence.

Woodford left his previous firm with a strong reputation and an impressive long-term track record to start his own shop in 2014. Following the relaunch of the strategy under the Woodford brand, his equity income fund proceeded to generate in excess of 20% return when his supposed benchmark was flat over the same nine months.

The relative experience since (Chart 1) will confirm that chasing his strong short term and long-term performance back in 2014 led to a poor future outcome. The fund's current operational and liquidity issues (which were a known risk to anyone monitoring his fund closely for many years), and the details of the red flags that led us to exit are not our focus in this article. We instead prefer to illustrate a far more general and important point regarding the importance of process over outcomes in investment due diligence.

The way most investors allocate to discretionary managers is to naively chase recent performance.

Part of the reason is due to the disposition effect - the tendency to take profit too early and hold onto losses too long (which can lead to some interesting anomalies in asset returns). However, this bias works in reverse when it comes to allocating your money to someone else (the act of delegation leads to a reluctance to redeem from managers that perform well and an urge to redeem from those who do badly). Other reasons allocators chase performance are due to the anthropological issues facing investment committees, which are usually bastions of groupthink and often driven by the HIPPO (the highest paid person's opinion). The harm in chasing performance as well as the behavioural and organisational traps it leads to, is why we choose to focus on process over outcome. For investors in regulated, open ended funds, consistent outperformance doesn't exist. **Investors need a deep understanding of the investment process to avoid repeatedly buying high and selling low. However, problems will still arise if the investment process changes.** ▸▸

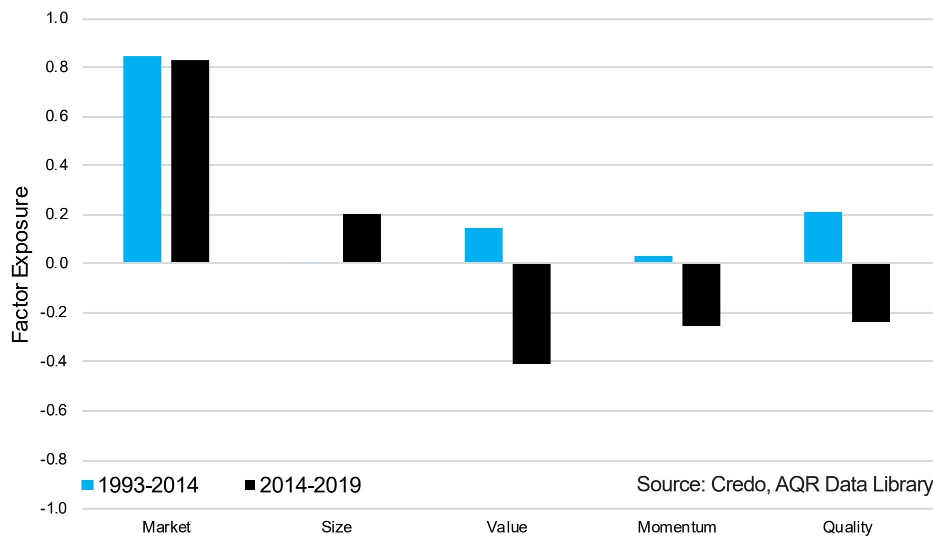


Chart 2 compares the ex-post exposure of Woodford's track record to different systematic trading styles in UK stocks up to 2014 and in the five years since. At the risk of oversimplifying, anyone less familiar with factor models can loosely interpret the numbers as "how much the portfolio co-moved with the relative returns of": the market, small cap stocks (positive number = small cap exposure), cheap stocks (positive number = exposure to cheap stocks), stocks in an uptrend, and stocks with high profits & strong balance sheets.

A naïve look at his long-term track record in 2014 would suggest you were investing in a fund which invests in cheap and high-quality companies… however the ex post experience since 2014 has been more in line with a fund invested in expensive, small caps of poor quality which have been falling in price. Many discretionary managers don't think of their portfolios in these terms and the analysis might not explain every risk this manager was taking (which also included US and unlisted securities). Yet it is useful since factor exposure usually explains significantly more of the variation in returns than the "alpha" (or skill), which is often just a tiny cherry on top. In this case, it also highlights the main difficulties of investing in discretionary managers - their process is often changing through time, with little transparency on how it will change in the future.

There are many similarities between the job of an allocator and that of a football manager. Using this analogy to illustrate the issue: you spend a huge amount of time scouting the perfect players for each position and structuring your perfect formation. But all your preparation is wasted if once the match starts your goalkeeper has decided he would rather spend his time in opposition's box trying to win the golden boot or your defence decide they prefer to start playing rugby (ala Boris Johnson).

A focus on process over outcome changes the way investors engage in the allocation decision - money managers are no longer treated as oracles and instead viewed as engineers, providing you with your desired exposure. This perspective leads us to focus on rule-based systematic strategies. This doesn't help us predict the future of the markets, which we believe is a fool's errand in itself. But it does enable us to have more confidence that the strategies we invest in will remain consistent given any future scenario, enabling us to construct portfolios in a more reliable fashion. There are good algorithms and there are bad ones but they all have a quality that is fundamental to investing which most human investors lack – *discipline*. The same inputs always give the same outputs. And the liquid and diversified nature of most systematic strategies also minimises the risk of encountering the same issues facing Mr. Woodford at the moment.