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Continuous Improvement in Investment Process Design – Standing out from the crowd

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Content

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Introduction

The process used by portfolio managers to select investments is central to the success of every investment firm. Formal reassessments of an investment process often only occur when there is change in firm leadership, or when there is an issue with not meeting portfolio objectives. Embedding continuous improvement of the investment process as an alternative to occasional, formal reassessments, is the subject of this white paper.

Why continuous investment process improvement is necessary, what opportunities there might be to consider, and how to implement this philosophy are the central questions addressed.

Being the best

Your firm already has an investment process that has been forged over time. So I'm not going to tell you how to build an investment process from scratch. But your competitors are getting tougher, markets are more challenging in ways that are both broad (e.g. global) and deep (e.g. high frequency trading), and customers have other choices of managers, and they expect to hire and retain only the best money managers.

If you are not the best investment management firm under consideration by a prospect, how do you expect to win the mandate? Everyone included in a finals presentation has been carefully vetted, and their investment performance is terrific. However, there is always one manager who will stand out. Investment process can often be the factor that turns prospects into clients.

Your investment process is the link, in their estimation, to future results. New clients can't benefit from your historical performance; they can only participate in your future performance. Your people who inspire your process can provide clients with the comfort that the represented historic performance will be sustained long into the future.

Investment process also then becomes a cornerstone of your ongoing relationship with clients. A sound investment process sustains client relationships by helping to comfort them through the inevitable periods of investment under-performance.

Your robust process can help your clients to achieve longer returns for their funds in the long run.

Client's portfolios benefit from higher realized returns over time, if they stick by you and refrain from churning investment management firms due to temporary underperformance. Let's start with a tough question: what if you assume that your investment process is wrong? What would you fix first? These questions are often asked during periods of investment under-performance.

Response's to investment underperformance

The reasons for under-performance can be objectively analyzed using statistical and quantitative diagnostic tools that examine macro factors, style, capitalization, sector/industry weights, leverage and so on. These tools are a good starting point.

Perhaps the under-performance was within reasonable limits in relation to investment style, for example. If the rationale given to clients also reflects the root causes of the underperformance, you may not need to mess with the investment process. You may conclude that the under-performance is a temporary phenomenon, and therefore make no changes to the investment process.

As an aside, leaders still have some work to do to assist the investment team even if no changes to the process are needed. Leaders need to be alert to the feelings of your staff during these periods of investment underperformance. Portfolio managers are bound to be psychologically affected by portfolio under-performance, and they may be paralyzed, unable to make decisions. As a leader, you must make sure that the under-performance has not undermined the ongoing ability of your portfolio managers to do their job.

There is a big problem

If the under-performance has been significant or persistent, it may be necessary to take action.

Since the investment process is created by people, we typically ask – who is responsible for the under-performance? Is it a team issue, or is it due to an individual? You'll need to review responsibilities, decision-making authority, and consider whether to restructure, hire, fire, or add staff.

As an example of this challenge, I know a firm that has a very coherent investment philosophy, and had been in business for 20 years at the time of my contact with them. The retirement of most of the founding generation of the firm led to many new hires who shared the investment philosophy of the founders. However, the execution of the philosophy was not the same after the founders retired. Governance, specifically investment decision-making, was upset as few of the old-guard remained. Within a few short years, the firm tried three different governance structures for making decisions about portfolio selections and construction. Various combinations of individual responsibility, larger decision-making teams and smaller groups were all briefly tried, and discarded. Investment performance deteriorated, and remained fallow for many years. Addressing investment process governance needed to be at the very top of the firm's agenda.

Sometimes, the issue is not one of needed focus, but instead a matter of perspective. When I started managing bonds in the early 1980's, none of my peers in the industry had seen a bull market in their entire career, and yet there we were on the cusp of a bull market that's now lasted for 30 years. Some fixed income managers of that era were never able to make the transition to benefit from the secular decline in interest rates.

Things do change sometimes, on a semi-permanent basis. When tectonic shifts occur in the investment business, some managers have difficulty recalibrating their investment approach. Their mental models become a handicap. The investment process changes required are then monumental, and risky for both the firm and its clients.

If significant investment process changes need to be made, you'll have to consider the secondary impacts both externally and internally.

Consider the impact on your firm's reputation, if for example, you were to replace individuals, or consider any other significant and observable modifications to your investment process.

Internal staff also may be concerned about the implications of any changes for their careers.

When the performance issue reaches the acute stage, resolving the issue becomes extraordinarily difficult. You might need to consider merging, closing or selling the capability, if the negative reputational impact arising from under-performance is significant enough.

Continuously reviewing and enhancing your investment process can help to avoid such traumatic shifts for your firm and clients.

Investment process adaptation

Investment processes are often adjusted over time, although rarely in a continuous way. Every investment process has formal guidelines, and informal rules of thumb, that need to be reviewed regularly.

For example, a value equity team had a rule of thumb for many years that required a minimum upside target price of 50% for all new investment ideas. However, they ultimately concluded that this rule of thumb was unsuited for a variety of market conditions. At the peak of a market cycle, the probability of a 50% return from any stock was low. Even under normal market conditions, some stocks were projected to offer less than a 50% return, but with commensurately lower risk. During bear markets, forecast individual stock returns on average, were much higher than 50%. The team decided to modify its strict price target in order to open up potentially rewarding risk/return possibilities under all market conditions.

More generally, across the industry we have seen a much greater emphasis on managing risk as well as return, in a more formal way. This may be the biggest change that we've seen to investment processes in the industry in recent years.

Sometimes the investment process needs to be reengineered, because of internal inefficiencies that have crept into the firm. Over time, any process has steps added as circumstances demand. These additional steps may impede the process. For example, spreadsheets requiring manual entries may become a part of the process. Eventually, the process becomes dysfunctional. Regularly you need to ask why you are doing what you are doing.

Theories from manufacturing

Investment managers can learn something from the practices of other industries**.** Lean thinking has been used for decades in the manufacturing sector, and it is exemplified by the Toyota Production System. At its core, the belief is that any activity that doesn't add value to the customer is waste. To translate this to our industry, it could be suggested that anything that doesn’t directly and positively contribute to the process of selecting a security, or building a portfolio, is a waste of effort. Every action that we take needs to contribute value to the end product, which in our case is usually portfolio performance. I have drawn heavily on the ideas of lean thinking and similar process improvement programs for this white paper.

Process improvement introduction

What prevents you from consistently generating desired investment performance? What is the biggest constraint, or bottleneck that you face? What if you were to focus on overcoming this constraint, and making this effort the first priority? Then once the constraint is resolved, you could then move onto the next bottleneck. Constraints could be in the form of tasks or the flow of investment ideas in your process.

An example of a task constraint may be having too little proprietary research. Hiring people is expensive, but if you conclude that it is limiting your investment performance, you need to focus on resolving it.

Or you may choose to improve the speed of the flow of opportunities considered within your process. Increasing the number of relevant opportunities that you are able to review may contribute to portfolio results.

Perhaps both tasks and flows need to be addressed simultaneously. What if each security purchased met your expectations for its contribution to return, risk or correlation. Not every security needs to be a big winner, just as in football, a quarterback sneak is not designed to gain considerable yardage. But ideally, each security should meet your reasonable expectations.

How could you enhance your process so that you come closer to achieving the results as anticipated?

You could consider building experiments into your process. Use the scientific method and develop a hypothesis, test it, and review the results. Creative, insightful investment ideas could be validated using a more rigorous framework. Balancing the scientific method with creativity can unlock opportunities for improving your process.

You can't rely only on your historic investment performance to validate the quality of your investment process. You can instead continuously improve your process, which can contribute to consistent outperformance, by eliminating waste.

Removing waste from the investment process

In the November - December 2011 issue of CFA Magazine, Ralph Langer wrote an article about investment process entitled, "Of Laundry and Lavish Compensation". He admonished investment professionals, "…it is very important to spend your time looking at things that are important… We all spend a lot of our time doing routine chores that someone has to do … Your first priority should be to minimize the amount of time that you spend on [chores]."

We'll next examine the types of chores that create waste in the investment process. We will look at these sources of waste from two directions – the impact on performance in the short run and long run, and secondly, how often they are encountered, and can be influenced. After reviewing these opportunities to enhance your investment process, you can choose to focus your attention on the ones suggesting the greatest opportunity for improvement in your investment process.

A convenient summary table of these opportunities is also included at the back of this white paper.

Investment process enhancement

Let's start with items that are less often encountered, and that have a modest impact on performance in the short run, and also consider how we might improve our process.

First, if decision-makers reject investment ideas regularly, internal research effort has been wasted. For example, let's assume that the rejections are consistently those presented by an individual who is competent, but is perhaps new to the firm, and not yet familiar with what it takes to have an investment approved. New hires may be very smart, and in some cases, very experienced, but they are working in a new environment. Shortening the time that it takes for your new people to make a full contribution, in the context of your firm's culture, is important. Good investment process design can help speed the enculturation process. We might consider some form of mentoring, training or standard-setting in order to improve the productivity of this individual quickly.

Second, in larger organizations there are often multiple investment teams, sometimes located in numerous offices across the globe, who may share overlapping portfolios. Sharing knowledge is not an easy thing to manage, and it has the potential to be a waste of time. Designing virtual team interactions is needed to derive benefits.

Third, there are administrative errors of various kinds that require the intervention of portfolio managers. Minimizing these interventions through middle and back office improvements can enhance portfolio managers' ability to focus on managing the portfolio.

Fourth, technology can help to reduce wasteful manual processes. In any process, unanticipated issues require a work-around, and these issues may accumulate over time, slow the process, and affect results.

Now let's look at some issues that occur more frequently, but still, in the short run at least, may have only a slight impact on performance.

First, motivating staff is something that should happen every day – expressing thanks for example. If efforts to motivate fall short, the impact on performance will not be immediate. However not having well-designed monetary and non-monetary incentives in place will eventually lead to employee turnover and disrupt the investment process.

Second, we can be burdened by an excessive amount of unnecessary and inefficient communications, for example, e-mail and meetings. Spending time thinking about ways to enhance the contribution of communications to the investment process can be valuable.

Third, unstructured conversations and social time with the sponsors, managers and promoters of investment opportunities reduces productivity. While improving the quality or efficiency of these conversations won't have an impact in the short run, the information gathering process of your firm shouldn't be slowed by unproductive social activities.

Now let's turn to look at elements that either occur less frequently, or are subject to modification less often, but may have a high impact on performance in the short run.

First, most investment ideas require some investigation, and in some firms these ideas require a lengthy proprietary report, in order to support a decision. How long does it take from the germination of an investment idea through to its inclusion in your portfolio, on average? Security price movements may be too rapid, and overtake a relatively slow investment process. A good buy idea at $10, may not be such a good idea at $20. Not being able to respond in a timely way will have a meaningful impact on portfolio performance. Do you insist on lengthy written reports for recommendations? If so, how timely is the preparation of these reports? Are there exceptions to this process? Does having lengthy reports demonstrably add to investment performance? As an aside, do you also prepare reports when adjusting positions, or when you sell or close out positions?

Second, deciding when to put risk on or take risk out of the portfolio is generally not an event that occurs every day. However, the decision making process, and the execution of any changes to the portfolio should be efficiently handled.

Third, hiring the wrong person is costly to any organization. It is difficult to know what impact a mis-hire has on portfolio performance, but clearly a poor hire is disruptive in the short run. Carefully determining needed competencies which support your best talent, and behavioral interviewing are powerful techniques to reduce errors in the hiring process.

Here is an example of how one firm considers competencies in the hiring process. A leader of a major investment firm recently described how they consider professional staff from two perspectives. First, the individual must have “commodity skills” such as a knowledge of accounting, economics, competitive strategy, how to calculate discounted cash flow and prepare valuations. Second, professional staff also must have “differentiating skills” such as the ability to identify a limited set of pivotal issues that will drive the performance of a security, the ability to think strategically and creatively about how to implement their investment insight, and finally an instinct for finding opportunity. The challenge is then to identify these characteristics in the recruitment process.

Fourth, professional staff departures may have a dramatic impact on portfolio performance, and an employee retention strategy is important.

Fifth, managers may occasionally adjust risk to either "lock-in" gains,or elevate portfolio risk in order to recover from under-performance. These actions are not only highly risky from an investment perspective, but they may also jeopardize the firm’s reputation. Unusual deviations in risk should not be permitted in a portfolio, for any reason, other than investment opportunity, or at a client’s request.

Sixth, the investment process must be able to support a move in a new direction quickly. For example towards the end of economic cycles, the financial leverage of companies and the portfolio is of increasing concern to most portfolio managers. If a portfolio manager wishes to reduce the exposure to financial leverage in the portfolio, is there a process to quickly alter the portfolio's characteristics? If not, there may be significant effort required to make the desire changes, and the decision risks being untimely.

Many money managers are unprepared for significant market changes. Using current market conditions as our starting point, we usually focus on pushing ideas into the portfolio. We survey the landscape of opportunities, and through a series of steps, we reduce the universe of possibilities to a smaller number of securities for our portfolio.

There is another way to think about this, however. One can think of the investment process as a pull process, where the portfolio's objectives, demand for outperformance being one example, lead us to be responsive to market changes through preparation and an accommodative investment process.

If market prices change, we should have an inventory of investment ideas to go to.

Seventh, succession happens rather infrequently, but your clients care about how you intend to seamlessly transfer responsibility for a portfolio from the existing staff to others. If your transition process is not seamless, the impact on performance may be severe.

Our final set of suggestions for enhancing the investment process are those items that have a potentially high impact on performance in the short run, and occur, or are subject to influence, relatively frequently.

First, if the batting average for investment ideas is declining from an individual or a team, it is obviously important to dig in and understand why this is the case, and to try to identify and eliminate the causes.

Second, portfolio managers need to be able to evaluate as many relevant potential opportunities as possible quickly. Time management is a key skill.

Third, in recent years there has been a lot of work done on behavioral biases, which need to be anticipated and guarded against within your investment process.

Fourth, many firms have teams of individuals who work together, and superficially share an investment style. For example, a value investing team may include individuals who believe in a wide spectrum of different sub-styles within the value domain, which may cause personality clashes, and performance issues. These issues need to be resolved immediately.

Fifth, clients are increasingly demanding to see portfolio managers, and this demand for more frequent contact detracts from spending time on managing the portfolio. Managing client demands has long been an important skill set, but it is becoming ever more important.

Sixth, not all security selections in a portfolio always follow the precise investment process described to clients. There are always exceptions to the rule. The question is, are these exceptions contributing to the portfolio, and is the breach of process sufficiently remunerated for the extra risk?

Seventh, every investment process should incorporate a feedback loop from both successes and failures in order to further refine the process over time.

Sales influence - for better and worse

An investment process may also be enhanced by considered feedback from the sales force. Experienced sales people can directly help to upgrade the quality of the firm's investment process, by asking the right questions. I know a marketing leader who has a list of 1000 questions (!) that she poses to managers that she represents. It is probably much better for her to ask, and have these questions considered by the investment professionals in advance, before they are stumped at a critical meeting by intense questioning from a determined prospective client or consultant. Aside from the marketing benefits, these questions may also trigger some refinements to the process.

But a note of caution here. On the downside, sales feedback, if too forceful, can be detrimental. Even with the best of intentions, the effort can backfire.

Staff resistance

Why might investment professionals reject continuously improving the investment process? First, they may be happy with the current process, or too busy with other initiatives. If they are familiar with lean techniques, they might suggest that there's too much variation in the investment process as a result of the dynamism of the financial markets to standardize and eliminate waste. The concern might be that this is all about cutting costs and this effort could impact creativity.

Leaders might also worry that too much emphasis on standardization could dumb down the work of their professional staff, discourage talented employees, and push them to seek jobs elsewhere. There is clearly a tradeoff between the savings from standardization, and pushing out costly, yet productive, creativity and investment inspiration.

Implementation

This way of thinking about the investment process is a philosophy, a belief, in the importance of methodically testing every aspect of an investment process.

This cannot be a top-down implementation effort. It has to be led from the bottom-up, and driven by individual employees working together with a common objective. Leaders may initiate the launch, and set goals for continuous process review, and manage how the organization moves from where it is today to the desired state. However, every process improvement must be initiated by the same people who will be responsible for its implementation. They need to be tasked with increasing their own effectiveness.

The discussion with portfolio managers about process improvement should begin with identifying alternative solutions, and this includes the status quo as one alternative. The core principle should be that facts, not opinions, should guide decisions.

In any change effort, there are challenges. There may be other concurrent business initiatives, and even recently completed changes, that still need to be embedded in the organization. Portfolio managers in particular are averse to bureaucratic initiatives, and so they are going to need help in understanding how continuous process improvement makes a difference to them.

You have to anticipate that there will be at least some employee resistance. If investment performance is currently good, why mess with the process? If performance is weak, it may be argued that that this is a temporary condition, or that there is no time available to waste on new ideas.

Leadership challenges

The challenges for leaders include employee resistance, the need for preparation for the introduction of these ideas, persistence in seeing them actively considered, overcoming the challenge of competing initiatives, the intangible nature of the effort, and the time before results can be measured.

The steps to success include reviewing the portfolio objectives, having leaders who are engaged in driving needed changes, a bottom-up planning process, a project plan with action steps, responsibilities and a sequence of events, frequent communication, effective execution and ongoing reporting of the enhancements and key learnings.

Russell Campbell is the CEO of Your Second Opinion, LLC, a management consulting firm to asset/investment management leaders, and a registered investment adviser. Russell was the CEO of a top 20 ranked pension investment advisory and consulting firm. Previously, he was the Executive Vice President for a large regional bank and responsible for the Investment and Trust Group which was ranked in the top 60 in the U.S. From 1998-2006, he was the President and CEO of one of the 100 largest asset managers in North America, an affiliate of a major global bank. He personally started up a successful new foreign investment subsidiary for the bank. Prior to this, Russell was a Partner of one of Canada's top ten investment counseling firms. Russell's first leadership position was as the head of pension fund investments for a major Canadian bank. Russell has an MBA in Investment Finance and Marketing from York University, and he has a BA in Industrial Relations from McGill University. In addition, he attended the Advanced Management Program at INSEAD in France. He is a Chartered Financial Analyst, and a Certified Financial Planner ™, and currently holds Series 7 and 24 licenses.

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Your Second Opinion, LLC is a management consulting firm that partners with leaders of asset/investment management firms to drive their firm's success more quickly, and grow profitably.

INVESTMENT PROCESS DESIGN	*LONG- RUN IMPACT*	*SHORT-RUN IMPACT*
HIGH FREQUENCY OF OCCURRENCE/MORE OPPORTUNITIES TO INFLUENCE	1. Motivating staff. 2. Excessive communications - e.g. email, meetings. 3. Unstructured conversations/ social time with sponsors/ managers of opportunities.	1. Too many unsuccessful investment ideas. 2. Lack of time to consider all investment ideas. 3. Behavioral biases. 4. Team members with superficially similar investment styles. 5. Frequent client contact. 6. Portfolio selections outside of normal process. 7. Learning from experience.
LOW FREQUENCY OF OCCURRENCE/FEWER OPPORTUNITIES TO INFLUENCE	1. Rejected investment ideas. 2. Sharing knowledge effectively across multiple investment teams. 3. Correcting administrative errors. 4. Technology to replace manual processes	1. Untimely reports. 2. Timing of adding risk to the portfolio. 3. Mistakes in hiring. 4. Staff departures. 5. Adjusting risk for appropriate reasons. 6. Prepared to adjust portfolio characteristics. 7. Developing successors.