Investment Consulting Craft Trades Up to 21st Century[i]

By Ron Surz

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Successful investment consulting encompasses two distinct crafts: the ability to develop quality advice and the skill to deliver that advice – the solution craft and the relationship craft. This article focuses on the pressing need for modernization and improvements in the solution craft. Clients deserve to benefit from what we have learned about investing over the past two decades. We've learned a lot, but not much of it is reaching our clients.

Before we go any further, I should point out that the relationship craft has been evolving quite nicely and, in fact, has never been in better shape than it is today. The deliverer of advice has risen up from report schlepper/salesman to trusted adviser. The consulting industry has compensated for its lack of advancement in the quality of advice by significantly enhancing the delivery of that advice. Now it's time for clients to get the quality goods.

Relationship craftsmen seek out the best advice but are generally limited to those services developed by the solution craftsmen employed by their firm. Asset allocation studies and manager due diligence are the bread and butter of investment consulting. Relationship craftsmen want to believe that their firm's approach to these services is state of the art, but they are not. We've learned a lot but are using very little of it.

The consulting profession is relatively new, originating in the 1970s. In the first two decades there was a flurry of creativity and solution development. The industry embraced Modern Portfolio Theory (MPT), which is now almost 60 years old so it could be renamed Mature Portfolio Theory. MPT was used for both asset allocation and manager due diligence, but was found lacking in due diligence so peer groups and indexes became the barometers of choice.   Then these first two decades were followed by the dark ages of investment solutions – very little has changed. Twenty years later consulting still embraces MPT, peer groups and indexes, which would be fine if these actually worked.

We've learned a lot in the past twenty years but clients are not getting the benefits of this wisdom. On the asset allocation front, we've discovered the shortcomings of MPT. The very glue that was supposed to keep markets efficient has instead created inefficient bubbles and dislocations. Investor behavior has wreaked havoc upon capital market prices and created the profession of behavioral scientists who tell us this dissociative behavior is not irrational, its just humans being human. Stuff happens, and will continue to happen. We've also learned that risk is not volatility, its failure to achieve objectives. On the due diligence front we've learned that peer groups are loaded with biases that cause them to mislead rather than differentiate. Similarly, indexes are poor barometers of success for all except index huggers, and most style indexes are poorly constructed.

So how should the solution craft integrate these lessons? Asset allocation should focus on client needs and be more adaptive to market dislocations. Mean-variance optimization is not what the client needs or wants. Rather, policies should be structured and monitored for the achievement of objectives. For example, the truly wealthy can be best served by a "pockets-of-money" solution that matches future spending needs with bullet Treasury Inflation Protected Securities (TIPS). For those less fortunate, the consulting process can integrate savings with investment policy; the medicine of more risk can frequently be replaced by saving more and working longer. The consultant can also be a strategist who monitors bubbles and the like. For example, the VIX volatility index was screaming warnings well before the 2008 market meltdown. Savvy investors were bidding up options to protect and profit, and this panicked outlook was quickly reflected in the VIX.

On the due diligence front it's time to get serious about the two central questions that must be addressed:

1. Do we like what this manager does?
2. Does this manager do it well?

The first question sets the stage for the second. We need to understand what the manager does, which can be a challenge in some circumstances like hedge funds. If we don't understand we don't invest. The first question sets the benchmark. Then the second question examines the alternative of passive implementation. We can pretty much replicate just about any investment strategy with passive inexpensive blends of mutual funds or ETFs. This second question is best addressed with hypothesis testing and modern holdings-based attribution analyses. Peer groups and indexes do not work – never have, never will. Hypothesis testing compares the manager's actual performance to all of the possible outcomes from what he does. For more details, please see [Surz, 2005 and 2006]. Modern holdings-based attribution analysis explains why the manager has succeeded or failed, being very careful to get the benchmark right, because if the benchmark is wrong all of the analytics are wrong. Both hypothesis testing and attribution are best implemented using indexes that are mutually exclusive and exhaustive; there are only two such index families and neither are commonly used.

So will the next twenty years be like the last? Let's hope not. Nostalgia isn't what it used to be. My view is that the craft of developing investment advice will move down three separate and distinct paths. One path will support the continuing evolution toward packaged solutions by providing the best advice and guidance to the masses as a commodity. A second path will maintain the cottage-industry focus on individual and tailored solutions for unique client needs. Both of these paths for the solution craft will ultimately discover the value of recent advances in technology for enhanced decision-making, and the sooner the better. The third path for the craft will be extinction. Like those artsy crafted chairs of the 1950s that you couldn't actually use, some will continue to cling to the craft of the 1980s and become obsolete.

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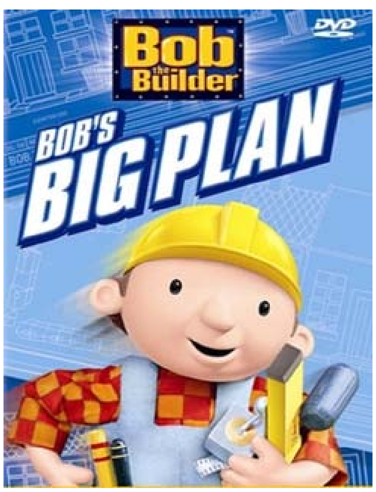

Use the right tools for the job.

[i] This article was originally published in 2002 and has been widely distributed since then. Its purpose is to provoke thought and stimulate innovation. Still not much has changed since 2002, other than we continue to learn more, little of which has been integrated into our solution set. It is this author's hope that this new article succeeds as a catalyst for change this time.