# SYSTEMATIC INVESTING

Our investment philosophy and process:
The foundations of a successful investment experience.

## THE PURPOSE OF INVESTING

Investing is the process of delaying consumption from today to sometime in the future and employing that money in the meantime in the markets to grow at a rate at least in line with inflation, but preferably more. The lifestyle goals that you want your money to achieve for you need to be carefully defined. In turn, these lifestyle goals can be translated into financial goals against which your portfolio will hopefully deliver suitable mid- to longer-term returns. It is defining this sense of purpose that sits at the heart of good financial planning and which allows for the construction of a portfolio strategy that you will be able to live with both emotionally and financially. So far, so good.

As the old saying goes, however, investing is simple but not easy. This note summarises what we believe to be a sensible and highly effective way to invest your money. Investing may never be easy, but it can be far easier once you employ a systematic approach, like the one we have designed.

## START BY BUILDING YOUR INVESTMENT COMPASS

Investing money well requires a logical and robust framework on which to build a lifelong investment programme. It needs to be grounded in investment theory, supported by empirical evidence and enhanced with an insight into the behavioural traps and pitfalls that all investors face, that can and do cost them dear.

Albion Strategic Consulting
Copyright © All rights reserved 2016.

# FIVE LIFELONG PRINCIPLES

We start by looking at five guiding principles that provide the backbone for how we should think about investing, rather than what we should invest in.

## 1. Have faith in capitalism and confidence in the markets

Capitalism is an adaptive, robust economic system that has delivered incredible developments to the benefit of mankind. For example, the wealth creation of capitalism has meant that over the last 25 years, around 2,000,000,000 (two billion) are no longer trapped in crushing poverty[1] and child mortality rates have fallen by over 50%. Despite the apparent doom and gloom, the world's economy continues to grow, year-on-year, creating wealth and return opportunities for investors.

As investors, we need to keep faith in capitalism as a robust and resilient economic system and recognise that the markets are an efficient mechanism for rewarding those who provide capital to those engaged in the pursuit of wealth creation. The future looks bright from where we are sitting.

## 2. Accept that risk and return go hand in hand

One of the inescapable truths of investing is that to achieve higher returns, you have to take on more risk[2]. That seems logical enough, but you would be surprised just how many investors seem to think that it is possible to get high returns with low risk. Yet risk should not be feared, because when appropriate risks are taken, they are the source of returns that investors seek.

The one thing we know for sure about risk is that if an investment looks too good to be true, it probably is. If you ever see such an opportunity, you need to establish what the hidden risk is as you have not spotted it. Risk and reward are always related.

## 3. Let the markets do the heavy lifting

In investing, there are two main sources of potential returns. The first is the return that comes from the markets and the second is the return generated through an investor's skill.

At its simplest, there are two main ways in which an investor – using their skill - can try to deliver a better return than the market return: one is to time when to be in or out of the markets (market timing), the other is to pick great individual stocks (stock picking).

Empirical evidence suggests that trying to beat the market – through either market timing or stock picking - is a tough game, with very few long-term winners. Our view - in line with both academia and many major institutional investors - is that it is not a game worth playing. Letting the markets do the heavy lifting on returns takes a great weight off your shoulders; you no longer need to worry about picking the right stock, the right manager or deciding if you should be in or out of the markets. As one cannot control the returns of the markets, the structure of your portfolio becomes key.

## 4. Be patient - think long-term

One of the great challenges that all investors face is that there is no easy or quick way to investment success. Aesop's fable of the tortoise and the hare is a useful metaphor. You have to use the time on your side – which could be over multiple decades – to capture the returns of the markets effectively, but often slowly. In the short-term, market returns can be disappointing. The longer you can hold for, the more likely the returns you will receive will be at worst survivable, and hopefully far more palatable. It is time that allows small returns to compound into large differences in outcome for the patient investor. The reality is that markets go up and down with regular monotony.

If you want to be a good investor, you have to be patient. On your investing journey, you will spend a lot of time going backwards, recovering from the set back and then surging forward again, often in short, sharp bursts of upward market movement. You just have to stick with it. Remember that you have to be in the markets to capture their returns. Impatient investors tend to lose faith in their investments too quickly, with often painful consequences.

## 5. Be disciplined

Patience and discipline are close bed fellows. Once you realise that to generate good long-term returns takes time, patience and belief in the markets, it is essential to put in place the discipline to stop yourself succumbing to impatience and ill-discipline. Discipline comes in many forms: sticking to the principles above; constructing well-researched and tested portfolios that should weather all investment seasons relatively well; not chasing investments that have gone up dramatically, but sticking with the logical reasons for not owning them in the first place; and the discipline to not become despondent about short-term, unimportant market noise, and to focus on your long-term strategy.

We know from research in the field of behavioural finance that we tend to feel at least twice the pain from losses compared to the pleasure from gains of a similar magnitude. So every time portfolio falls, investors feel glum. The key to this discipline is to understand the very ordinariness of these market falls and not to look at your portfolio too often. If you look at your portfolio every day you have about a 50/50 chance of seeing a loss, yet over five years that drops to around a 1-in-10 chance, falling further to around a 1-in-20 chance over 10 years[3]. Time is your friend.

Albion Strategic Consulting
Copyright © All rights reserved 2016.

# FIVE EFFECTIVE INVESTMENT PRACTICES

Having established a sensible set of investing principles, let's turn our attention to five key investment practices that the evidence and theory suggest we should focus on.

### 1. Build a well-structured portfolio

Once you accept that returns come from markets and are rarely enhanced by the judgemental approaches of professional managers of market timing and stock picking, it is evident that structuring a well-thought-out mix of different investments (referred to as asset classes) should sit at the heart of your investment programme. Your long-term portfolio structure will dominate the investment returns obtained during your investment lifetime[4].

Successful investing is all about taking on well-understood risks that deliver a positive return expectation – these are carefully selected market risks associated with ownership and lending[5]. It avoids taking on risks that add little (or worse) to the portfolio, such as illiquidity, poor judgemental portfolio manager performance, and opaque and complex product structures.

### 2. Use diversification to manage an uncertain future

Not putting all of your eggs in one basket is an intuitive and valuable concept. No-one knows what the future holds and owning a highly diversified portfolio spread widely across asset classes (bonds, equities and commercial property, for example) and across global markets, industry sectors and by company, helps make sure that we are prepared for whatever the markets throw at us over time; a portfolio for all seasons, if you like. Diversification is the key tool that we have against the uncertainty of the future.

Owning a diversified portfolio brings its own challenge. Inevitably there will always be one or two parts of the portfolio that are doing well, but one or two that are not. The patient and disciplined investor knows that there is little point in knee-jerk responses, and that this is simply the way that markets are. The impatient and ill-disciplined will seek to change their strategy. More fool them.

### 3. Avoid cost leakage from your portfolio

Costs eat away at the market returns that you should be gathering for yourself. Small differences in costs will compound into large differences over extended periods of time. Investment industry costs are high, particularly those related to judgemental (active) managers. The costs of investing are more than simply the annual management charges (AMC) charged by the fund manager. Other fund related costs can also be offset against the fund's performance which roll up into the ongoing charges figure (OCF). Yet that is not all. When a manager buys and sells equities or bonds they incur transaction costs, which eat further into returns.

If one takes two portfolios with the same gross (pre-cost) returns - one with a low cost of 0.25% a year and the other with a high cost of 1.5% a year – the low cost strategy will, on average, end up with a staggering 65% more money in the pot over 40 years[6].

### 4. Control your emotions using a systematic, disciplined approach

Unfortunately, evolution has hard-wired the human brain to be particularly poor at making investment decisions. A deep seated sub-conscious battle is constantly being waged between greed and the desire for reward against the fear of uncertainty and loss, which creates on-going anxiety and irrational decision-making in many investors. Investing is certainly not emotionally easy. Evidence of wealth destroying, emotion-driven decision making is plentiful, as impatient and ill-disciplined investors have a propensity to chase fund managers, and markets, that have previously performed well, and sell poorly performing investments. Buy-high, sell-low is not a good investment strategy. Research[7] reveals that this bad behaviour may cost investors around 2.5% per annum, on average. Given that equities have only returned around 5% above inflation, on average, that is a material erosion of potential wealth.

Recognising that both investors and advisers suffer from a range of behavioural biases that are more likely than not to result in the erosion of wealth, we believe that the design of a disciplined, systematic and understandable investment process, and its on-going implementation, is central to your success as an investor, reducing this 'behaviour gap' as the industry calls it.

### 5. Manage risks carefully across time

Our approach to investing positions us as risk managers, rather than performance managers as advisers have traditionally been. We have identified three key areas of risk management.

The first is rebalancing a portfolio: having spent considerable effort ensuring that a client's portfolio is both suitable for them and robustly structured, it is important to keep it that way. Rebalancing involves selling out of better performing assets and buying less well performing assets i.e. selling, rather than buying 'hot' performing asset classes. This enforces a systematic, rather than a market valuation based, defence against possible market bubbles. Rebalancing is simple in concept, but in practice it is hard to do; it requires considerable discipline and fortitude, particularly at times of market turmoil, when our emotions, particularly fear or greed, are heightened.

The second is fund selection: choosing which funds to recommend to our clients is a big responsibility that we take very seriously. We employ a detailed and insightful due diligence process to ensure that we are asking the right questions from product providers. Our focus is always on risk management that starts with eliminating fraud, explores operational risks, then focuses on product structure risks and finally looks at the ability of the fund firm to deliver market returns effectively.

The third is ongoing governance of the investment programme: it is entirely possible, and likely, that your portfolio will look much the same between one time period and the next with little activity, except for rebalancing. That most definitely does not mean that nothing is happening. We hold regular Investment Committee meetings that focus on reviewing any new evidence supporting or challenging our approach, the latest research on asset classes, and additional due diligence ensuring that our best-in-class funds remain just that.

Albion Strategic Consulting
Copyright © All rights reserved 2016.

# BUILDING YOU A PORTFOLIO FOR ALL SEASONS

The first thing to remember is that there is no absolute best way to construct a portfolio, but there are certainly some portfolio structures that are more sensible and more robust than others. A brief outline of our portfolio construction approach is provided below.

### Deciding on the asset class menu

One of the biggest challenges that all investors face is deciding what asset classes to invest in and what to avoid. The spectrum of choice is wide, from cash and UK equities, through to fine wines and Ecuadorian rainforest. We base our choices on each asset class' ability to meet our pre-determined selection criteria. The discipline of this framework allows us to review any asset class or investment strategy that crosses our desks in a systematic way. Having to analyse it against our criteria, forces us to engage our reflective mind, which defuses much of the emotion that might exist. Being entirely comfortable with the assets held in your portfolios ensures that when markets get tough, as they will from time to time, you are better placed to remain disciplined and stick with the strategic decisions that were made in calmer waters.

### Growth and defensive assets – the two components of your portfolio

Your portfolio will comprise two components; the first is what we call 'growth' assets, which are higher returning, equity-like assets. To own an entire portfolio made up of these higher risk investments – however well-diversified - would take some staying power when markets are in turmoil. So, most investors require a balancing allocation to assets that perform a high-quality defensive role, which tends to be predominantly high-quality bonds. We call these 'defensive' assets.

### Growth assets – the engine of portfolio returns

The growth assets component of your portfolio represents a logically constructed, globally diversified mix of risk assets that seeks to deliver strong mid-single digit, after-inflation returns over medium to longer-term investment horizons. Developed market equities (e.g. the US, UK, Germany and Japan) sit at the core of the growth assets component. We also include – in moderation - return enhancing assets such as emerging market equities (e.g. China, Taiwan, Brazil and South Korea), smaller companies and less financially healthy 'value' companies, which, on account of their higher risk, should deliver a return premium. Global commercial property – being offices, retail and industrial buildings – can be a useful diversifier. The growth assets component of your portfolio is highly diversified at the asset class, geographic, sector and company levels, and contains exposure to several thousand companies in over 40 markets.

This part of your portfolio will be volatile, with negative returns likely in around one-in-three annual periods; that is fine, as it is the nature of markets. Large falls in value may well be experienced at times of market turmoil. Remember that a fall only becomes a loss if you sell, something that patient and disciplined investors should avoid. Remember, too, that your holding in defensive assets will help to reduce any fall in the value of your portfolio at these times.

### Defensive assets – balancing the portfolio

For more cautious investors – with low levels of growth assets – defensive assets provide lower levels of potential falls than equity markets and should preserve purchasing power over time, although this is not guaranteed. For investors with higher levels of growth assets, defensive assets provide strong protection against equity market trauma.

Returns are expected to be only a little above inflation over the longer term. Short-dated, high credit quality bonds provide useful defensive properties. Their short-dated nature – the amount of time until the bond matures and capital is repaid – tends to lead to lower volatility than longer-dated bonds. High credit quality – on average around AA credit rating – tends to attract money fleeing from riskier assets at times of equity market trauma, driving prices of these bonds up. Any currency risk is hedged out, to avoid the volatility associated with exchange rate movements. Inflation linked bonds, such as the UK index-linked gilts, can provide an insurance policy against this risk, and may be included in your portfolio.

### Identifying the portfolio that is right for you

Finding the balance between growth assets and defensive assets that is most suitable for you is one of the most important decisions that we will make together. There are three distinct areas that need to be understood and addressed: first, we need to understand your emotional tolerance for taking on investment risk being the point at which you feel most comfortable, when balancing the trade-off between risk and return; second, we need to understand the worst magnitude of any falls in the value of your portfolio that you can survive financially; and finally, we need to establish how much risk you actually need to take in order to achieve your goals.

Defining the right level of risk to take is not simply the prescriptive output of the tools we use (cash flow modelling and psychometric risk profiling) but requires careful discussion, and the resolution of the trade-offs that you may need to make. This ensures that you end up owning a portfolio that has a good chance of delivering on your unique emotional and financial objectives.

### Implementing the strategy using systematic, not judgemental funds

We like to talk about the way we invest as being systematic. What we mean is that we do things according to a disciplined system that is efficient, methodical and objective. Low cost – which also means low activity – is key. This approach is sometimes referred to as passive investing or index tracking. Logic and evidence drive us toward a systematic approach.

The opposite of a systematic approach is a judgemental approach, which can be described as where a fund manager has the ability to act according to their own discretion or judgment to make subjective forecasts of short-term market or security prices in order to try to beat the return delivered by the market. This is often referred to as active investing.

### Why we prefer systematically managed funds

We hold a deep conviction that in selecting well-managed, low-cost, systematically managed funds, we will be providing you with the best chance of capturing the bulk of the market returns that are on offer, which is a worthy goal. Trying to identify judgemental managers, who can persistently overcome their fees and costs to deliver market beating returns is extremely difficult and requires long track records to discern skill from luck. Picking funds that will even be around is a tough starting point, given the poor survivorship record of the industry. Living with the inevitable underperformance that will occur from time to time when employing judgemental fund managers is not for the faint hearted and may well lead to impatience and ill-discipline; and we know where that leads.

Albion Strategic Consulting
Copyright © All rights reserved 2016.

# FINALLY

We hope that this short note has provided you with a good insight into the key principles and investment practices that guide our systematic approach to investing.

We are confident that our approach will provide you with every chance of having a successful investment experience. We cannot guarantee what returns the markets will deliver in the future, but we can guarantee that you will capture most of what is available through our systematically managed, best-in-class funds. By owning a well-diversified portfolio for all seasons, having faith in capitalism, allowing the markets to do the heavy lifting, being patient and remaining disciplined, you give yourself – with our continued help and guidance – every chance of success.

If you have any questions on anything in this document, or you would like to talk through our investment approach in more detail, please contact us and we can arrange a time to talk.

## Important notes

This is a purely educational document to discuss some general investment related issues. It does not in any way constitute investment advice or arranging investments. It is for information purposes only; any information contained within it is the opinion of the authors, which can change without notice. All information is based on sources the Firm believes to be reliable. No responsibility can be accepted for actions taken as a result of reading this document.

## References


1. Human Development Report 2015: Work for Human Development', United Nations.
2. Sharpe, William F. (1964). 'Capital asset prices: A theory of market equilibrium under conditions of risk', Journal of Finance, 19 (3), pp. 425-442.
3. Albion Strategic Consulting – internal research 2016.
4. Brinson, Gary P., Hood, L. Randolph, and Beebower Gilbert L., (1986) 'Determinants of Portfolio Performance', Financial Analysts Journal, vol. 42, No. 4, pp 40-48.
5. Fama, Eugene F., and Kenneth R. French, (1993) 'Common risk factors in the returns on stocks and bonds', Journal of Financial Economics 33, 3-56.
6. Sharpe, W. F., (2013), The Arithmetic of Investment Expenses, Financial Analysts Journal, Volume 69 · Number 2, 2013 CFA Institute.
7. Mind the Gap 2014 by Russel Kinnel, Morningstar. http://news.morningstar.com/articlenet/article.aspx?id=637022


## HELPING YOU TO GET A BETTER RETURN ON LIFE


The Gatehouse Business Centre
Mansion Gate
Leeds
LS7 4RF

T. 0113 262 1242
F. 0843 658 5323
E. info@thefinancialadvicecompany.com
W. www.thefinancialadvicecompany.com



The Financial Advice Company is a trading style of TPFA Limited, which is authorised and regulated by the Financial Conduct Authority. FCA reference number 611188.
Registered in England and Wales as a Limited Company No. 8453762.

Albion Strategic Consulting
Copyright © All rights reserved 2016.