

Investment Philosophy & Process

Context

Before even beginning to think about investment planning we all have to make some decisions about where we want to go and why. And what choices we will have to make to get there. At one extreme there are those who will never consider the future, never have any real plan or goal as to where they want to be, both professionally and financially, in ten, twenty or thirty years time. At the other there are those who know exactly where they want to be, what they want to be doing and when. Between these extremes there are many grades of clarity, ambition and goal setting.

Most of these ambitions and goals in some way involve money. As a fund to enable their achievement, as cash flow to allow their implementation or perhaps as an end in itself. Ultimately we can only escape the thrall of wage slavery by either having nothing or enough. Clearly 'nothing' is not generally an option our clients would consider. The amount that is 'enough' will depend on our own personal preferences, needs and desires.

All of which is a long-winded way of explaining that investment planning does not take place in isolation. It is not, or should not be, something separate to the rest of our lives. To be successful, and efficient, it should be set against a background of clear and achievable goals. It should be part of an holistic financial planning process that allows for risk and integrates with our personal and professional plans and ambitions. It should be disciplined and have clear simple targets.

In our experience the two biggest threats to the success of investment planning are a lack of planning and a lack discipline.

Our job is therefore threefold. One to help you construct a realistic financial plan, two to provide a discipline to the achievement of the plan and three to advise on and administer an efficient risk rated and successful investment strategy.

Williams Farrall Woodward Approach to Investment

1. General

Over time we have developed what we feel is a consistent process to managing client money. There are five key factors that define this process.

Market Efficiency

We believe that markets are efficient. This is not to say that markets are perfect pricing mechanisms in all cases. Mis-prices clearly do occur but it is so difficult for any active manager to consistently find and exploit these mis-prices and hence 'outperform' the market, that it is not worth even trying.

Value will always reveal itself

Various studies have shown that a 'value' approach consistently outperforms a growth approach. By 'value' we mean stocks with a high book value to market capitalisation ratio. In other words the value of the business assessed by conventional accounting methods divided by

the market capitalisation should be a high ratio. This book to market ratio is assessed relative to all stocks in the market. These are characteristics of the stock and the market, not the company.

Cost control is essential

The costs of running a portfolio will have a dramatic effect on performance. Consider an average actively managed mixed fund that may achieve a 6.5% annual return. The annual management charge may be 1.5% and the total expense ratio 2.0%. From this we deduct our servicing rebate of 0.5% leaving a net charge of 1.5%. 1.5% from 6.5% leaves 5% return to you (4.5% after you pay us). A reduction in return of 23%. We aim to invest through companies that charge well below the market average for retail funds.

Asset Allocation is key

Various academic studies have consistently shown that about 90% of the return of a portfolio is achieved by asset allocation not stock selection.

Asset allocation is the balance between the four main investment asset classes of cash, bonds, property and shares. Asset allocation in respect of shares alone is the balance between different market segments for example large cap and small cap and 'value' and 'growth' stocks. Managing the relative proportions of these within a portfolio in respect of your attitude to risk and time is the most certain way of achieving the desired outcome.

Diversification reduces risk

Holding just one stock or even just one fund exposes you to market and specific risk. But just buying another fund or share would not diversify your portfolio if they have the same characteristics. For example, holding Shell and BP would not necessarily be diversifying. With funds it is necessary to ensure that the underlying holdings are not correlated otherwise one would just have more funds, not less risk. So any risk factor that can be reduced or cancelled out by diversification should be.

2. Academic Background

2.1 Market Efficiency

Securities markets are efficient. By efficient we mean that all information about any security is available to and known by all investors and the price of the security reflects this situation. Clearly this does not mean that the market always gets the pricing "right". However the moment a security is miss priced the market recognises it and the price is corrected.

2.2 Active and Passive Management

Active managers seek to outperform the market or a segment of it by selecting securities that they feel are mis-priced and then realising the gains when the price is corrected by the market.

Passive Managers seek simply to capture market rates of return. Index funds do this by buying a statistical sample of the securities that make up the whole market. There are other forms of passive management.

Many Studies have been carried out to check whether or not active management works. That is, can it deliver a consistent out performances over time. All these studies, at least those with true academic rigour, have shown that they cannot. In other words they are unable to consistently identify mis-prices and to profit from them.

We are therefore sure that active management offers no advantages for the retail investor.

Are therefore index-tracking funds a suitable substitute? Certainly they have lower costs but do they offer a better way of capturing market returns?

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Index funds attempt to replicate the market by the use of a statistical sample of the market. They usually use a computer algorithm to manage this process, which will trigger buys and sells as required to maintain the accuracy of the sample. Very often these buys and sells are executed in a manner that materially affects the share price and frequent dealing increases the costs of the fund. Furthermore it is difficult for index tracking funds to properly sample and efficiently deal in the less liquid sectors of the market, for example smaller companies.

Index tracking is not the only passive management technique available. If we agree that passive management is about market and stock characteristics, not company characteristics, is it possible to structure a fund that minimises the value and trading issues inherent in pure index tracking? We think it is and we discuss passive management in more detail below.

2.3 Asset Allocation

As we have stated above academic research (and our own experience) shows that over 90% of the returns on any investment fund come from asset allocation rather than stock selection.

Investment is defined as an asset that has a cash yield. There are only four of these in the world and they are:

- Shares (dividends)
- Bonds (interest, yield or coupon)
- Property (rent)
- Cash (interest)

These four main classes can be further subdivided into sectors or segments for example:

- Shares Smaller companies Large companies
- Bonds Short dated Long dated
- Property Commercial Domestic
- Cash Sterling US Dollar

The diversification across asset classes and sectors reduces risk. For example there is a negative correlation between stocks and bonds. Additionally certain asset sectors have different return characteristics that can be utilised to match portfolios to clients specific risk tolerances.

2.4 Risk

We must be clear exactly what we mean by risk. In our view this is the volatility of returns as measured by the standard deviation of those expected returns.

It must also be appreciated that without any risk there would be no return. It will depend upon each investor and his attitudes as to how much risk he is willing to take to achieve the desired outcome.

3 Investment Solution

3.1 Generally

Academics, financial economists and many investors have long realised that it is possible to capture simple market rates of return by the use of passive investment techniques.

However simple sampling of the whole market may not provide the best returns or even risk adjusted returns.

In particular the seminal research into securities data going back to 1927 by two US based economics professors revealed that three main factors provide a key to higher returns. These three factors are:

Equity Market

(Complete value weighted measure of stocks)

Stocks have a higher expected return than fixed income securities.

Company Size

(Measured by Market Capitalisation)

Small company stocks have a higher expected return than large company stocks.

Company Price

(Measured by company book value to market equity)

Lower price "value" stocks have a higher expected return than higher priced "growth" stocks.

The equity market factors give an indication as to how a portfolio maybe constructed to give the highest expected returns. However, there is a correlation between risk and reward. The higher the risk the higher the potential reward. Clearly therefore a portfolio of smaller company value stocks will have a higher risk as measured by the standard deviation of the returns than a portfolio of larger company growth stocks.

The same professors also studied the historic data sets for fixed income securities to see if there were similar factors that could be found that defined the returns to be expected.

This research revealed that two main factors needed to be considered, these were:

- Term to maturity
- Premium (The spread over the risk free return)

Given the above the expected returns of a portfolio can be expressed as a five factor model. These being the sum of the three equity factors and the two fixed income factors.

3.2 Portfolio Construction – Risk Management

We believe that the main function of fixed interest securities in a portfolio is to reduce risk. That is to reduce volatility, the standard deviation of returns. We do not target income yields or growth rates but seek to achieve a total return (capital gain – or loss – plus income received) for a given level of risk. The level of risk is that acceptable to each individual client.

It is also the case that tilts in asset allocation to and away from different market segments will also increase or reduce risk and return.

3.3 Portfolio construction – asset allocation

In reality this is the same as 3.2 above, risk management. We balance your exposure to different asset classes and segments to provide rate of return compatible with the risk you are prepared to take.

3.4 Portfolio Construction – Passive Fund Manager

Given the foregoing it is clearly possible to define a process for investing that could be run by any manager. In other words we are not selecting a manger for what he could achieve in running your money but how well he could apply and run a system of investment.

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There are a number of internationally based management companies offering this service but we have selected the oldest, Dimensional Fund Advisors Ltd.

Dimensional offer a range of funds on which we can base our risk rated portfolios. They are professional reliable and excellent value. However, they do not offer funds in all asset classes. These groups are in UK large capitalisation stocks and property. (We discuss property as an asset classes below).

For these two groups we are currently using Legal & General for the UK large Cap and Norwich Union for the property element. These selections may change in the future.

3.3 Property

In this case we are considering only commercial property. We do not believe that buy to let or similar speculations are relevant in this discussion although clearly they may have a place in any clients overall portfolio. We will consider domestic let property as part of the overall asset class of property when there is a substantial number in a portfolio.

Property itself is more commonly seen as commercial property owned through funds. Typically a commercial property fund will own both properties and property shares.

Property is an illiquid asset class with high transaction costs. Its main benefits as far as we are concerned are as a supplier of yield, i.e. rents and its apparent lack of correlation with other asset classes. Our research shows that it can have some benefits in reducing the risk (as measured by volatility) of a portfolio.

The downside is that all valuations are one of opinion. The market for property has many frictions and there is no day-by-day method of pricing the fund.

Overall we have decided to restrict the proportion of property in our standard portfolios to approximately 10%. This may change as we gain more knowledge as to how the class performs in the overall portfolios.

3.4 Active Management

We have observed that some clients still like some active management in their portfolios. If you absolutely insist on this we have one manager recommendation. At the present time we only feel able to recommend funds offered by Bedlam Asset Management. The reasons for this are:

- Charges. They only make money when you make money
- Management Style. Value managers for absolute returns.
- Attitude. Analytic, combative and suspicious.

4. Summary

- Active management is expensive and does not deliver any excess returns.
- Passive investment with a value tilt based on rigorous academic research can deliver consistent risk adjusted returns at a low price.
- Asset allocation is the key to returns.
- Fixed interest securities are used to control risk.
- Risk is the standard deviation of the main of returns.
- Absolute commitments to capital growth or income are ignored and replaced by total return.

Note: This is an overview of our investment process. For a more detailed analysis please see our briefing note No. 21 on Investment Philosophy.

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