Choosing the right investment approach

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Portfolio construction is all about investing in a variety of markets and strategies to create the most appropriate investment solution for investors. To do this effectively requires an understanding of how various types of investments work, and an ability to combine them so they address different investment objectives, goals and factors including risk appetite.

When building a portfolio, there are two very important stages that need to take place. The first involves identifying the most appropriate mix of asset classes. The second involves choosing the most appropriate investment approach to implement these assets into the portfolio. This includes deciding on the correct level of active management to use.

In the following article, Tanya Debakhapouve, Head of Public Market Solutions, discusses the important factors that need to be taken into consideration when identifying the right investment approach for a portfolio. She explains why different investment approaches lend themselves better to different investor circumstances, and why it's crucial that the investment manager is flexible in how they access the asset class.

Developing a deep understanding of investors' needs

As we learnt in an earlier article in our Building Better Portfolios series, investors have a diverse range of needs. Therefore, in designing portfolios, an important first step is to consider investors' investment objectives and goals, their risk tolerance, cost preference and time horizon.

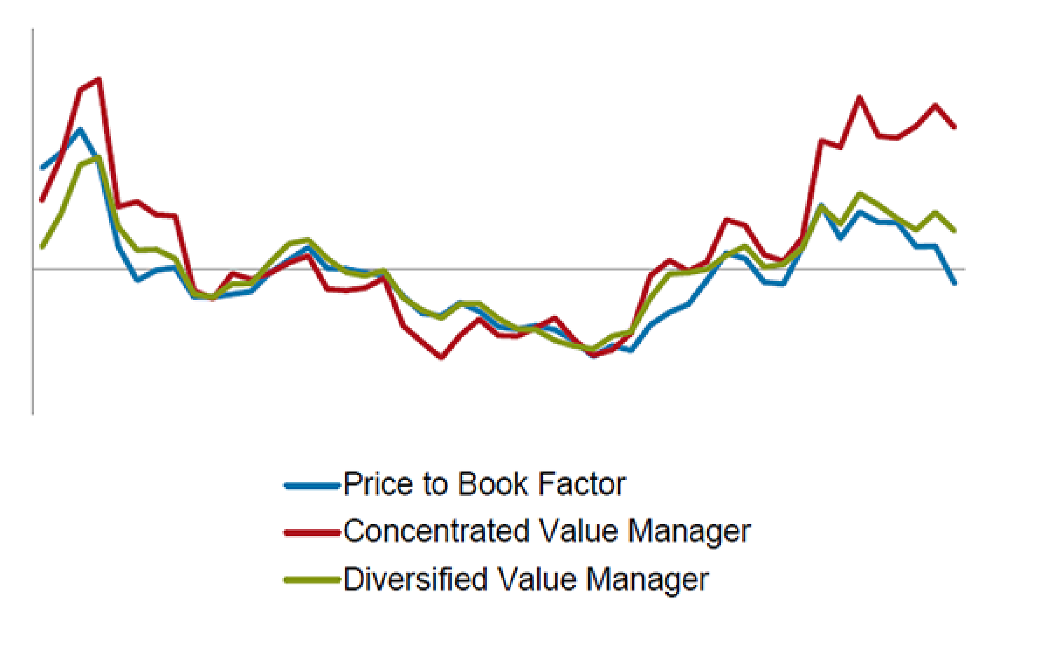
Having considered these aspects, the investment manager is then able to identify what it considers to be the most appropriate mix of asset classes to construct a fund that is designed to deliver to investors' needs.

What happens after we've determined the right mix of assets?

Once an investment manager has decided on the appropriate mix of assets, they must then decide how they are going to implement them into the portfolio. The choices available range from applying an indexed investment approach (which involves managing a set of funds to mimic a market index), an enhanced indexed approach (which combines elements of indexed and active management), factor based strategies, and a fully active approach. The latter can be delivered using a single manager or funds that include more than one active manager.

What are factor based strategies?

Factor based strategies are generally used when the portfolio requires a certain investment style (such as buying 'cheap' stocks) to achieve its goal. The strategies will invest in a large number of stocks that possess the required characteristics, and typically incorporate a set of portfolio construction rules to 'manage out' any unintended exposures. The attraction is that they can be designed to suit an individual investor's needs and, if well-constructed, can offer a pattern of performance that's consistent with an actively managed fund, but that's also more cost effective. The chart below shows a comparison of the excess returns delivered by an active 'concentrated value' manager, a 'diversified value' manager and a 'naïve' factor strategy based on a price to book metric[1]. In this case, the factor based strategy delivered a similar pattern of performance to the active strategy, but at a lower cost.



[1]Capitalisation weighted composite of stocks that represent the 'cheapest' half of the MSCI World Index based on the price-to-book metric, rebalanced semi-annually. NB a 'real life' factor based strategy can be based on more than one factor and its construction principles can be more sophisticated. Source: AMP Capital and eVestment.

Which is the right approach?

Just as choosing the right mix of asset classes should always start with a consideration of what is an appropriate investment objective, strategy and risk level, so too should choosing the right approach to implementing the assets into a portfolio. Once again, an investment manager should consider investors' desired levels of investment return and their ability to tolerate risk. And critically, over what time frame they are wanting to achieve these goals. There are additional factors that need to be taken into consideration. These include how likely it is that the manager can add value in a particular asset class or market, and also how active they are going to be in managing the portfolio's asset allocation. Management fees and other costs also need to be considered.

When active management makes sense

When markets are inefficient

An inefficient market refers to a market where securities are not always accurately priced and tend to deviate from their true value, either by being 'overpriced' or 'underpriced'. This can create opportunities for skilled active managers to exploit such inefficiencies, and generate returns for investors that are in excess of the benchmark.

The key to success is having a mix of active and/or factor based strategies that can effectively exploit such inefficiencies, and at the same time remain diversified so as to minimise any risks.

When portfolios use mainly strategic asset allocation

For diversified portfolios that have been built for investors with a long time horizon, and that use predominantly strategic asset allocation, it's generally appropriate to use active strategies at the asset class level. This is because actively managed strategies need to be given sufficient time to deliver their expected outcomes. For these portfolios, performance will be driven by a combination of the long-term strategic asset allocation, and also by the investment strategy, manager selection and portfolio construction decisions within asset classes.

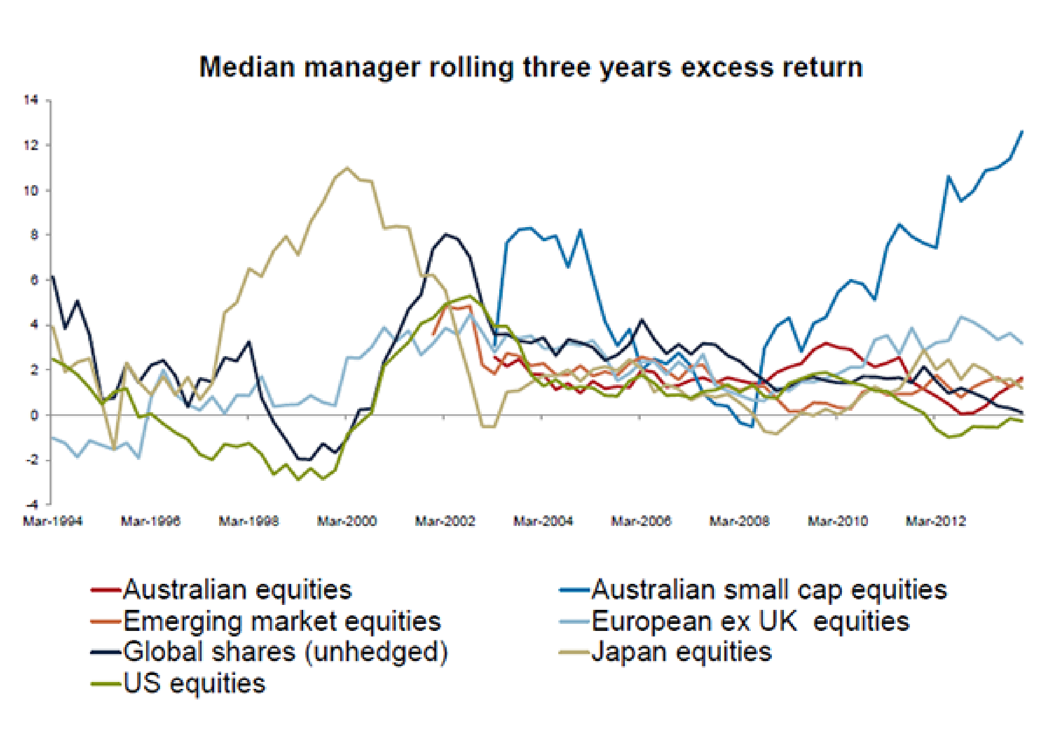
Managing costs and risks

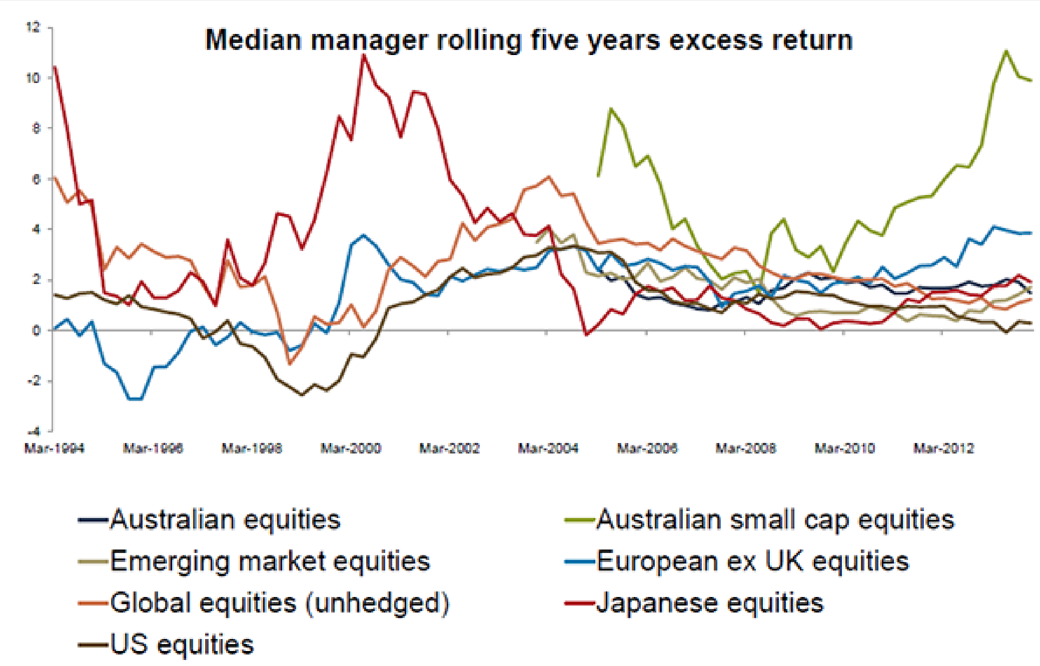
There is, of course, the risk that actively managed strategies may fail to outperform the benchmark. However, this risk can be managed by diversifying across multiple strategies or managers.

Also, the higher costs typically associated with active strategies can be reduced by using factor based solutions. These can replace some of the 'style' based active strategies within a portfolio. In addition, active strategies can be complemented with indexed or enhanced indexed approaches where appropriate which also helps reduce the overall portfolio cost of managing the portfolio.

Markets have different levels of efficiency

The charts below show excess returns that are delivered by active managers in their respective markets. The relative magnitudes of these returns reflect the relative levels of efficiency of each of the markets. For example, the fact that active managers in the US have delivered lower excess returns than Australian Small Caps means that the latter is less efficient. The charts also show that excess returns are generally delivered more consistently over longer time periods than over short time periods.





Source: eVestment.

When an indexed or enhanced indexed approach makes sense

When markets are efficient

The more efficient the market, the more difficult it is for an active manager to earn returns in excess of the benchmark – and the more suited these markets are to indexed and enhanced indexed strategies.

When portfolios are particularly active in their asset allocation

If the investor has a shorter time horizon and/or is more active in managing their allocation across asset classes, they may choose to limit their use of active management within asset classes. A portfolio that incorporates a dynamic asset allocation (DAA) overlay on top of its strategic asset allocation is an example of such an approach.

Broadly speaking, the greater the reliance on dynamic asset allocation, the more sense it makes to use indexed or enhanced indexed approaches at the asset class level. This is because DAA expresses a short to mid-term view of markets, whereas most active managers express a mid to long-term view. In such cases, using active management may 'interfere' with the purity of implementing that asset allocation view. As an additional consideration, the cost of trading active strategies to implement a DAA view may be higher than costs associated with using other strategies for this purpose.

For investors who are focussed on achieving a certain goal

It's worth mentioning that not all investors will make decisions based on the trade-off between risk and return. Many investors will require portfolios that help them achieve a certain goal – whether that's providing capital growth, delivering an income stream, preserving capital, or some other goal.

For such portfolios, a combination of active strategies and indexed investment approaches can be used. These can also be used together with 'factor based' solutions that are designed to deliver a particular outcome, expressed as a metric like dividend yield, quality or high earnings growth.

Flexibility in how an investment manager accesses the asset class is critical

Deciding on the best investment approach to adopt for a portfolio is something that needs careful consideration. For many, some combination of active and indexed approaches will make sense – but the degree to which a portfolio is tilted in one direction or the other will largely depend on the investor's attitude to risk, their investment time horizon as well as how they measure success. As different approaches lend themeselves better to different circumstances, flexibility in how an investment manager accesses the asset class will continue to be crucial.