Verus

Sound Thinking

IAN TONER, CFA

Knowing Where You're Going Matters

June 2020

It was both complicated and scary to be a dead Ancient Egyptian[1]. You had multiple different souls. You were presented with tests, and had to navigate a path through the underworld to reach the Hall of Two Truths. Here you would be judged and your heart would be weighed on a scale against a feather[2] – if found to be sinful it would be eaten by Ammit (a goddess who was part lion, part hippopotamus and part crocodile). An Egyptian who passed this judgement was rewarded with a happy life in the Plains of Aaru – permanent annihilation awaited those who failed.

Those who could afford it would be buried with a handbook to help them pass these challenges – a combination of guidebook, toolbox and magical cheat-sheet, often described as The Book of The Dead, although in fact there was never one single agreed-upon form of words used. The goal was to focus the dead soul on the things they needed to know and do to stay on the true path to immortality.

I am glad to say that being an institutional investor today rarely involves the risk of having your heart devoured by a lion-hippo-crocodile creature. But the path to a successful investment outcome is rarely simple, and the investor can easily find themselves presented with questions that feel impossible to answer without a proper guidebook. At Verus, to help with that process we use two different types of support. The first is the detailed toolkit that we create: Capital Market Assumptions, Risk Models, Liquidity Coverage Ratios, and the like. These are all vital and help us to answer many of the technical questions that come up throughout our investment journey. The second, however, is more foundational: our investment beliefs.

It is important to have a set of investment beliefs: not because you follow them mechanically, but because they tie your day-to-day decision-making back to the underlying core things you believe are at the heart of reality. It is also important to

1. *To start with, you were dead, which is generally unadvisable.*
2. *Representing ma'at (a term that means some mixture of fairness, balance, justice, rightness and honesty)*

spend time every few years reiterating those beliefs, and making sure that they remain front and center of the way portfolios are constructed.

At Verus we have had a core of investment beliefs for many years, but it has been some time since we have gone through the process of reiterating them – important because that process helps embed those beliefs in how we work. Over the last few months we have been presented with amazingly volatile markets and a series of pieces of news that would each individually seem unlikely, but that in fact have all happened at the same time. That seemed like a good time for us to go back to reiterate those beliefs, and I wanted to use this latest Sound Thinking to do that, to explain what each of these tried and true beliefs mean, and how they are intended to drive our investment thinking and behavior. The goal of this exercise is not just semantics. We do not just hold these views academically – we believe that building these ideas into our day-to-day helps us to think more clearly and leads to building better portfolios. If we continue to do this our (and our clients') hearts will remain uneaten – and we will continue to maximize our chances of producing outcomes that achieve the goals our clients have.

RETURN OBJECTIVES, TOLERANCE FOR RISK, AND THE STRATEGIC MISSION OF THE ENTERPRISE SHOULD GUIDE ALL DECISION-MAKING AND DRIVE STRATEGIC ASSET ALLOCATION

We begin with the most important consideration: what the investor needs. Those needs can be described along three main dimensions: return objective, risk tolerance and strategic mission. The first two of these (return objective and risk tolerance) work together – risk is the currency with which we buy returns – and it is important that clear and collectively-understood statements exist regarding the level of risk the investor can bear and the return they require. This always has to tie to the strategic mission of the investor: everyone involved needs to understand the potential impact on the strategic mission of unlikely, but possible, negative investment outcomes, and balance the probability these outcomes could happen with the impact if they do.

The strategic mission of the enterprise is important for another reason: it should be the basis on which any ESG policies are established. Those policies should be structured around the enterprise's mission and should take into account the possible risk and return effects. There is no one-size-fits-all approach to ESG.

GOOD RESULTS CAN BEST BE ACHIEVED BY MANAGING UNCERTAINTY USING A VARIED RISK MANAGEMENT AND INVESTMENT TOOLKIT, COMBINED WITH THE DISCIPLINE OF HUMILITY

We next address the question of risk and uncertainty. We all know markets are difficult to predict, and while there are tools available to help us paint a picture of what the future might look like, these tools only provide a partial picture of possible outcomes (and even then are generally very dependent on historical data). This means not only that the predictions investors make might be wrong, but also that when the models which investors use appear to provide quite rigorous answers[3] they may cultivate an overconfidence about the future based on a misleading level of precision.

3. *To as many decimal places as you ask them to*

To counter this we focus on using a variety of tools and approaches. None of them produce answers that are exactly right, but each of them helps us understand one view of what the future might look like. By combining them, and by understanding the assumptions that go into each model and the ways they might give misleading results, we can begin to help an investor piece together a picture of the possible outcomes that might occur.

The final part of this belief statement focuses on attitude, and the importance of what we call "the discipline of humility". Two things are important here. First, it is important that we always approach investment decision-making with an appropriate understanding of the difficulty of the task we are trying to accomplish[4]. Any time we start to feel over-confident we need to pull ourselves back. Second, humility is a discipline – a process – not just a cast of mind. You need to look at your decisions in a disciplined way, tracking what worked and what didn't, and holding yourself to account for the win/loss rate, which will for most investors create the appropriate level of humility about the next decision to be made!

Taking all of these things together helps keep the focus on the uncertainty involved in investment decision-making. Ironically, doing this should also gradually help build confidence in decisions made using appropriately diverse analysis.

RISK-FREE RATES AND RISK PREMIA DRIVE MOST MARKET RETURNS, AND ARE THEMSELVES INFLUENCED BY MARKET AND ECONOMIC FUNDAMENTALS

In one sense, the underlying drivers of most portfolios are fairly simple. Risk-free rates are the foundation of most investment returns, with core risk premia providing some relatively predictable additional return over those risk-free rates, at least over a full cycle. Focusing on getting these core underlying portfolio drivers right should be the primary job of investors: the other parts of the portfolio management process are additive, but secondary.

REQUIRED RETURN		RISK FREE RATE		BETA		ALPHA
7.3%	=	2.0%	+	4.8%	+	0.5%
				Absolute Risk 11.2% Sharpe Ratio 0.43		Active Risk 2.5% Information Ratio 0.2

We also believe that, over the long term, the behavior of these underlying market drivers is influenced by fundamentals that are both observable and somewhat predictable. Understanding these moving fundamentals is not an exact science, but continuing humble study of demography, markets, economies, political systems and structures, debt cycles, industrial and technological change can help

4. *Investors that even just manage to get only slightly over half of their decisions correct, but who combine that with successful risk and implementation management, will often do surprisingly well when compared to peers*

provide insights that may provide serious students of these topics advance warning of changes which will eventually show up in portfolio movements.

In other words: we try to read everything we can, even[5] things we disagree with or that challenge our preconceptions, and we look to the history of human behavior to gain insight into the future of human behavior, because human behavior drives the behavior of markets.

INVESTMENT SKILL EXISTS, AND THE DEPLOYMENT OF ACTIVE MANAGEMENT WHERE INEFFICIENCIES CAN BE EXPLOITED IS ESSENTIAL TO ACHIEVING INVESTMENT SUCCESS IN BOTH PUBLIC AND PRIVATE MARKETS

Although most investment return comes from risk-free rates and risk premia, skilled active managers exist, and can be used to generate additional return. These managers exist in a range of different markets – both public and private – but there are two major challenges investors face when considering active managers.

The first challenge is identifying skillful managers. We believe both the risk and the return dimensions need to be considered, and that there are managers who can manage along both dimensions to produce favorable outcomes. We also believe there is no statistically-robust way to identify skilled active managers in advance[6]: but that by focusing on the underlying characteristics of the firm and the process, investors can identify teams and processes which are likely to provide a good prospect of long-term value added. We believe manager research should focus on these long-term issues, and there should be a strong bias towards building long-term relationships with trusted managers who demonstrate the characteristics we believe are important. We also believe this needs to be combined with a ruthless sell discipline when the characteristics that gave us confidence in the manager or their process change. Short-term performance in itself tells us little to nothing about a manager. We neither hire nor fire managers based simply on performance.

The second challenge is providing managers a structure within which they can invest in a way that actually delivers alpha. Private market investment structures are designed for this – concentrated long-term portfolios, with long investment horizons, the use of leverage, and smoothed reporting[7]. Hedge fund structures can provide a similar framework, although the structure created needs to be aligned with the opportunity types concerned. Typical public market structures can make it harder for a manager's investment edge to produce sustained positive outcomes: holding for the long-term is more challenging in vehicles with daily liquidity and daily valuations, and these markets are often more efficient. In each case, investors need to understand the expected drivers of alpha, and ensure that they are allocating to structures which provide a reasonable prospect for allowing the manager to capture the coveted alpha.

---

5. *Or especially*
6. *The markets change, technology changes, investment processes change and people change. As all of these things change through time they change the process that is producing the results stream that might provide evidence of active skill. We can use that results stream to get insight – but we should not expect statistical proof, or we can both miss good ideas as we wait for proof, and fool ourselves when we see what seems like robust data which is in fact flawed.*
7. *Importantly these factors are not the things that generate performance directly: they simply create a framework that makes it easier for the manager to adopt an investment approach that allows them to capitalize on their skill*

FEES AND COSTS MUST BE MANAGED AND APPROPRIATE. SIMPLICITY IN PORTFOLIO STRUCTURE IS OFTEN PREFERABLE TO AND MORE EFFECTIVE THAN FASHIONABLE COMPLEXITY

Costs matter – but we avoid the use of the word minimized here. Instead we focus on whether costs and fees are managed and appropriate. This is important because an excessive concentration on simple level of costs and fees can lead investors to fail to implement strategies which will in fact, all things considered, produce better outcomes. Investors should focus on the whole of the investment proposition, with costs and fees an important part of that proposition but neither the first nor the last words.

Finally, we always want to be alive to the possibility that a complicated idea, which might be fashionable, might be less effective than a simple, tried-and-true, approach. Too often the investment industry produces solutions which are interesting to analyze and which generate excitement, but which turn out in retrospect not to have been worth the extra complexity[8]. If a simple solution to a problem is available, investors should consider it seriously, rather than simply following a newer, more fashionable, approach that may be no better.

Conclusion

The above ideas are, I hope, simple and clear, although in my experience when you begin to unpack their implications they are surprisingly rich. Our goal in reiterating these beliefs is to ensure that the underlying ideas behind stay, as they always have been, at the forefront of our minds as we build portfolios together with our clients. Nothing in them is – or should be – earth-shattering, but we believe that is part of their benefit. We are not trying to navigate the Egyptian underworld, nor do investors have to rely on magical spells to succeed. The process of institutional investing is one of staying on task and on target: none of the steps are themselves too complicated, but taken together they can help investors of all different types have the best chance of achieving their widely diverse investment goals.

8. *And complexity is, of course, usually expensive*

ABOUT THE AUTHOR

Mr. Toner has a degree in Law from the University of Oxford in the United Kingdom and is a CFA charterholder (Chartered Financial Analyst). He is a regular author and speaker on a range of investment topics. He is a member of the Audit / Finance Committee of The Medina Foundation in Seattle. He is also a member of the CFA Institute and the CFA Society of Seattle. Mr. Toner is a trustee of Charles Wright Academy, an independent co-educational school based in University Place, WA, where he also chairs the endowment committee. He is also a board member at the Seattle Metropolitan Chamber of Commerce, where he co-chairs the finance & audit committee. He has been happily married to his wife, Heather, for 25 years, and is the proud father of two children.

IAN TONER, CFA
Chief Investment Officer

ABOUT VERUS

Verus is an independent, employee-owned provider of non-discretionary consulting and discretionary management (i.e., OCIO) services to a wide variety of institutional investors, representing over $438 billion in assets*, including endowments and foundations, public pension plans, corporate defined benefit and defined contribution plans, and multi-employer trusts. Verus, renamed from Wurts & Associates in April 2015, has been advising institutional clients since 1986.

**Includes Verus' total assets under advisement; preliminary as of 4/1/2020.*

Pensions&Investments
2019 | LARGEST CONSULTANTS OF INSTITUTIONAL ASSETS
TOP 15 RANKED
WORLDWIDE INSTITUTIONAL ASSETS UNDER ADVISEMENT
VERUS

Verus®

800 Fifth Avenue, Suite 3900
Seattle, Washington 98104
206-622-3700
verusinvestments.com