

# AEIOU > PPPPP

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## Summary

*Manager research and selection have long been described in the language of Ps – people, process, etc. Verus believes the familiar Ps approach, while useful, leaves out important aspects of manager assessment and their products because of its focus on inputs. The Verus approach is grounded in key principles that focus on outputs and enables us to differentiate between products rather than merely describe them. We outline a vowel-based approach that concentrates research on factors that are more likely to drive investment outcomes.*



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## Introduction

In this paper, Public Markets Managing Director Marianne Feeley, CFA, outlines the Vowels framework, a principles-based way to ensure manager research is based on the qualities we look for, and not only the features that are also important. In this piece we will review the conventionally adopted approach to manager research where topics of due diligence are defined in terms of the “Ps” approach. We will describe the Ps and how they are useful as research inputs but not as helpful as criteria for differentiating investment products in terms of conviction they will meet their investment objectives. We will then introduce the Verus Key Principles (the Vowels framework) as a more useful way to focus research on factors that are material to outputs achieved by investment products. In conclusion, we will illustrate how Verus integrates the Vowels into its standard manager research process.

## Conventional Manager Research and Ps

Corner any investment professional who analyzes investment managers and their products, and it won't be long until they start to describe their research approach using the familiar language of “the Ps”. The Ps are a concept developed by marketing professor Jerome McCarthy<sup>1</sup> in 1960 to describe the set of tools a business uses to sell products or services to its target customers: product, price, promotion and place. The investment industry has since

borrowed the concept and redefined these terms, initially developed to describe the selling of a product, to the research process used to vet an investment product's ability to meet investment objectives.

There isn't precise agreement on which or how many Ps are ideal for this purpose. A random internet search turned up the following: people, process, price, performance, partnership, products, portfolios and parent. Philosophy also is mentioned, although technically a P only alphabetically and not phonetically. Most research frameworks agree on people and process; performance is often included but just as often excluded, perhaps on principle.

The Ps are useful as part of a research framework. They are intuitive and familiar, owing to their origins in marketing. They also serve as a good reminder of critical inputs for management of investment portfolios. It's difficult to describe an investment product without outlining the people responsible for decision making or the process for selecting investments and constructing a portfolio. However, their usefulness is also at the root of their limitations as criteria for a conviction-driven assessment of investment products. The Ps are ideal for when the aim is to describe – they fall short when the aim is to differentiate.

The key drawbacks of Ps as a research framework is due to their function as descriptors -- they are more coverage oriented than research oriented. They also tend to encourage a checklist mentality where all of the coverage elements are considered equally. An analyst addresses each of the Ps individually rather than focus on the integration of elements that work together in a successful investment product. Overall, the Ps focus more on the “what” of an investment product rather than the “why”. Yet, it's the “why” that better captures the reasons one “disciplined, risk-controlled, fundamental process managed by a deep and experienced team” is more successful than another.

### **Verus Key Principles (the Vowels)**

The Verus manager research framework is structured around a set of key principles that reflect Verus' research beliefs. The focus on research beliefs allows us to concentrate on the factors which are most likely to drive investment outcomes. To emphasize this shift in focus, we have deliberately defined them based on the five vowels (AEIOU) rather than a single consonant.

#### **While we look AT Ps, we look FOR Vowels.**

When evaluating investment products, Verus focuses on how the various inputs to an investment product work in combination to produce the aspects of that product that are consistent with a sustained ability to meet investment objectives in a consistent manner. The emphasis is on the outputs rather than the inputs.

Naturally, the inputs are relevant but evaluated in context rather than isolation. For instance, over the years we've seen the same process applied with minor variations across multiple investment firms. We don't evaluate the process alone, but consider the combination of skills, professional backgrounds, risk controls, incentives, organizational features, systems and other aspects that interact with that process for an optimal outcome.

The Verus key principles and the reasons we believe they are important are described below.

#### **Alignment –**

The strategy is supported by a stable organizational and team structure. Evaluation includes examination of the alignment of the investment management firm with its clients; alignment of investment management firm with its investment staff; alignment of investment staff with its clients. These relationships are examined by assessing the fund manager's business structure, fee structure and remuneration structure for investment staff. Alignment is an important concept that does not merely describe the people and organization but delves into incentive structures, business model and fee structures as tools to align interests of management, investment team and client.

#### **Edge –**

The manager has articulated an inefficiency or market-based belief that informs its investment process. This edge is typically expressed as an advantage over the benchmark but may also be evident as an advantage over peers. Evaluation includes examination of the market inefficiency the manager seeks to exploit; in other words, we are looking for the fund manager to express a market-based belief and to be willing to take risk based on that belief. We are also looking for evidence that belief is reflected in alignment, implementation, risk management and performance. Edge is an important concept that extends beyond an investment philosophy to elucidate how the other four Verus principles contribute to how the product is differentiated from its benchmark and peers.

#### **Implementation –**

There is evidence that the manager's investment approach is sensible and repeatable. Evaluation includes examination of the tools and processes whereby the manager turns its market-based belief into a portfolio of individual investments; we expect the manager's resources to be aligned with their market belief and their specific area of skill; we expect an investment process to be logical and repeatable and to make the best use of the manager's resources. Implementation is an important concept that encompasses philosophy, resource, people and process working in concert to produce a repeatable result.

### **Optimal use of risk –**

The manager has an effective framework to assess and manage risk inherent in its process. Evaluation includes examination of the tools and processes whereby the manager evaluates sources of risk in the portfolio, assesses whether they are intended risks or unintended risks, and appropriately scales the former and mitigates the latter. It also involves an examination of the sources of risk inherent in the process and the verification that intended risks are aligned with the manager's investment beliefs and areas of skill and resource. Optimal use of risk is an important concept that addresses both sides of the risk construct; it extends to the manager's ability to deliberately use risk where it has skill and to be aware of and control risk where it doesn't.

### **Understandable performance–**

There is evidence that historical performance appears consistent with the manager's expressed process. Evaluation includes examination of the manager's means to implement and manage risk through the lens of different market environments; the performance results are consistent with the manager's identified area of skill, and conditions when the product may outperform or underperform are well understood. Understandable performance is an important concept that is not limited to quantitative examination of return but also the understanding of how those returns reflect our expectations of the interaction of a manager's skill and resource with the investment environment. It is tempting to describe performance as "good" or "bad" and use it to apply judgement in a rear-view mirror fashion. Ensuring performance is understood ex-ante is one of the elements we believe to be essential to determining whether underperformance (or outperformance) is a concern.

The principles above embody subjective information used to evaluate manager skill. Embedded in these subjective evaluations is review of objective information including but not limited to: performance record, risk systems, portfolio holdings, vehicle availability and fees.

## **Illustrations and Examples**

Although we would like to make the claim, Verus has not discovered evaluation criteria that have never been considered before. However, we would point out that the Vowels framework is not merely a different version of the Ps. The following table illustrates how these concepts incorporate the broad set of inputs involved in an investment product.

<b>Principle</b>	<b>Ps Incorporated</b>	<b>Other Concepts</b>
<b>Alignment</b>	People, Partners, Parent, Product, Price	Incentives, Succession, Capacity, Attraction/Retention
<b>Edge</b>	Philosophy, Process, People, Portfolio, Parent	Culture, Resources, Tools
<b>Implementation</b>	Process, Portfolio, People	Research, Consistency, Logic, Adaptation, Tools
<b>Optimal use of risk</b>	Process, Portfolio, People, Performance	Skill, Holdings, Measurement, Tools, Adaptation, Liquidity
<b>Understandable performance</b>	Performance, Process, Portfolio	Learning, Environment, Style, Adjustment, Attribution

A few generic examples demonstrate how the Vowels contribute to clarity around degree of conviction in a product and changes or concerns.

The first example is an overall product description laying out the degree of conviction within the vowel framework:

**Alignment –**

*We believe that Manager’s partnership with Parent in 2016 allowed the firm more resources so that they can better focus on investing. Conversely, partnership with the large firm decreased the alignment of key investment professionals at Manager with firm outcomes. Incentive compensation motivates professionals to debate and challenge ideas.*

**Edge –**

*We believe the simplicity and structure of the team’s philosophy create an edge. The team believes that trends that benefit growth and profitability for the companies it owns tends to be more powerful and longer lived than widely believed. Manager is truly a research driven firm, and the independence of professionals in conduct of research helps to retain staff.*

**Implementation –**

*The stability of the team that operates under one shared philosophy helps the team make repeatable decisions. The team has access to resources such as people and technology that translate investment edge into a portfolio.*

**Optimal use of risk –**

*The approach is benchmark agnostic with an absolute return target over the cycle. Stock specific risk is the primary focus, and tracking error can be high. The team has focused more on its sell discipline recently.*

## Understanding performance –

*Long-term growth approach leads to better performance in risk-on markets; broad portfolio may suffer in narrow or momentum-driven markets. The product is not appropriate for short-term benchmark-oriented clients.*

The second example illustrates how we use the Vowels framework to analyze change in investment management firm and put that change in context of the principles-based elements that support conviction in the product.

*Our initial read is that Smith's hiring is part of Manager's long-term business continuity and succession planning. Speed of implementation of Manager's research agenda appears to be the primary area that Firm management are looking to improve with Smith leading the charge. As for the departure of Jones, we viewed her as a competent member of the team, but not necessarily integral. We view these changes as something to monitor, but no reason for immediate action. Given the organizational change, we will watch for any material changes to the investment team (none are expected).*

The third example reflects reaffirmation of conviction in a product that endured significant underperformance in 2018.

*Based on this meeting, we are reaffirming conviction in the Manager's strategy. On balance, we believe the recent succession related issues, new incentive structure, and strategy line up rationalization were thoughtfully handled and make sense as the firm tries to maintain proper alignment with outside investors. From an investment and risk management perspective, we appreciate the continued emphasis on identifying, profiting from and rewarding short ideas along with the ongoing effort to better position portfolios for rapidly changing regimes across the market. Finally, we are pleased to see the fund post strong short-term performance during the current equity volatility as it digs out from its 2018 drawdown.*

## Conclusion

*It is important when assessing actively managed investment products, to make the distinction between inputs and outcomes and to use each appropriately. We believe framing the inputs to an investment product by looking at Ps (philosophy, process, etc.) is certainly useful to ensure we have considered the key features of that product. However, if we stop there, we have engaged in more of a cataloging exercise rather than a critical assessment of the product's value proposition. We view the Vowels (Alignment, Edge, Implementation, Optimal use of risk, Understandable performance) as the differentiators we are looking for rather than merely descriptors we can look at. By implementing a Vowels-based approach to manager research, Verus focuses attention on the aspects of an investment product that are critical to drive investment outcomes.*

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<sup>1</sup>Anderson, L. McTier, and Ruth Leshner Taylor. "McCarthy's 4PS: Timeworn or Time-Tested?" *Journal of Marketing Theory and Practice* 3, no. 3 (1995): 1-9. Accessed May 19, 2020. [www.jstor.org/stable/40469759](http://www.jstor.org/stable/40469759).

## Disclosures

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