FRONTIER ADVISORS

The Frontier Line

Thought leadership and insights from Frontier Advisors

Why is an investment philosophy important?

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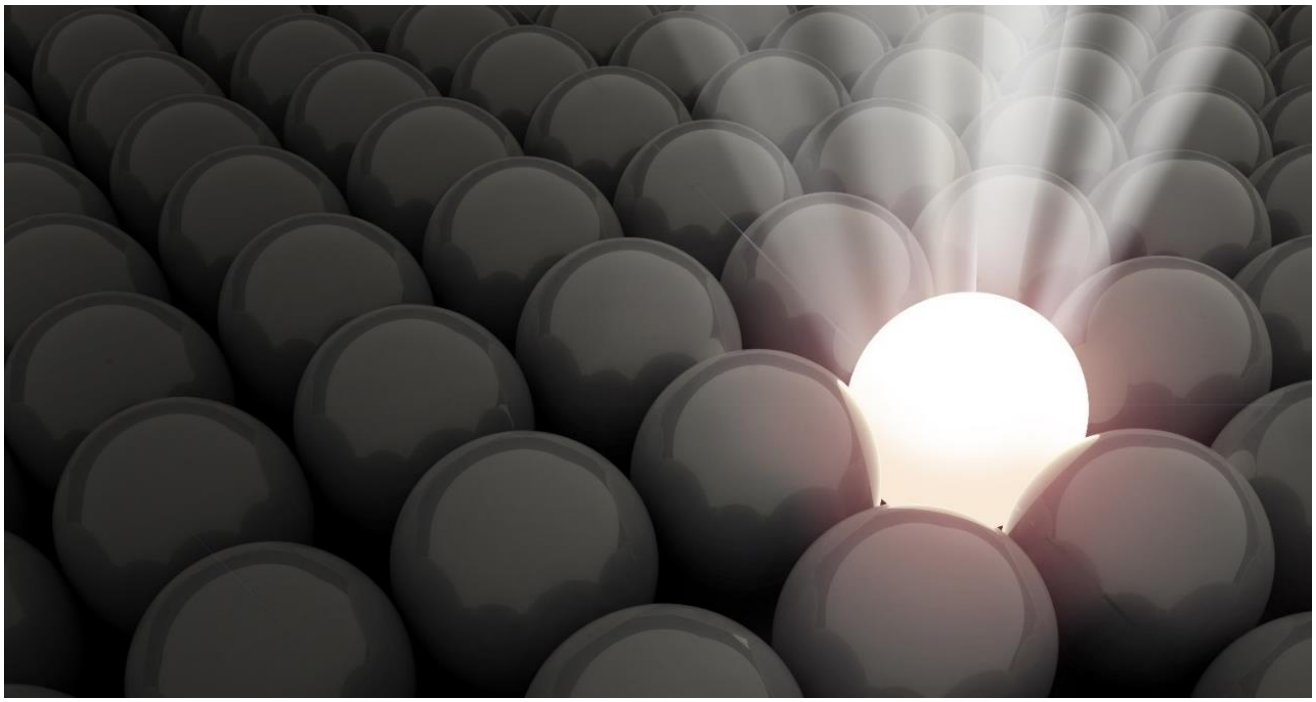


Fiona Trafford-Walker is Director of Consulting with Frontier Advisors. Fiona is one of Australia's most respected investment consultants and has been advising institutional investors for more than two decades. A foundation staff member of Frontier Advisors, Fiona was recently listed as one of the world's top 25 most influential investment consultants by the respected international finance journal aiCIO, and named "Woman of the Year" in the inaugural Women in Financial Services awards presented in November 2013.

Investment philosophy

Whilst having an investment philosophy might seem like a fundamental concept, it is not uncommon for institutional investors to lack a formal detailed statement. However, what is even more common, even amongst some of the nation's largest investors, are outdated and rarely referenced statements. Fiona Trafford-Walker examines the purpose and importance of a well and clearly documented investment philosophy.

"Risk comes from not knowing what you're doing"

Warren Buffet, an outstanding long-term investor.

An investment philosophy is a roadmap for your fund

Imagine you are driving around France (or whatever your dream destination is!), without a map or a GPS. All you have are signs that appear from time to time telling you what towns or villages are coming up and how far away they are. You can also use the sun during the day and perhaps some landmarks to give you a general guide, or you can guess where to go, but most likely you will get lost and end up in the wrong place, or at best, in the right place but late.

You really needed a map. That's essentially what an investment philosophy gives any investor – a map of where you are going and how you plan to get there.

A clearly prepared, well supported investment philosophy can help investors stay on track against a long-term goal, especially when short-term events conspire against you.

In the same way a map doesn't predict for unforeseen events, like road closures or bad weather that might take you away from your planned route, an investment philosophy doesn't predict financial crises, member behaviour, or funding issues, but it can help you develop a response plan if those events occur.

Individual investors versus groups of decision makers

Most institutional investors make decisions in some form of group. Boards or Investment Committees are generally responsible for setting the "big picture" requirements, including investment philosophy and beliefs, asset allocation and related parameters, and so on.

Having an investment philosophy when a group makes decisions is particularly important as it creates a centralised point that can be referred to at any time.

Of course, long-standing Directors are valuable if they can remind others of what was agreed and why, especially when things go "wrong".

However, a clearly written investment philosophy is even more tangible and can act like a true "port in the storm" reminding members why decisions were made and providing them with the direction they need to see a difficult position through.

This is not to say any underperforming investment should not be reviewed, or the investment philosophy used as a defence without doing the work, but if thenvestment case and the future prospects remain sound, then a reference to the investment philosophy is appropriate i.e. it explains "why did we do this in the first place?"

Investment philosophy

What should an investment philosophy statement look like?

An investment philosophy statement should reflect the kind of investor you are, what you believe in, and how you think you (or those who invest on your behalf) can make money, including the timeframe you believe you need to make that money, and how you believe you will meet your goals.

It should be in writing, held somewhere where it is easy to find, and regularly consulted.

It is important an investment philosophy statement is clear and able to be understood by a range of stakeholders. It should contain statements about how you think you will earn returns, how you will manage risk, and the market conditions that do, and just as importantly, do not suit your approach.

You may also like to include comments on your philosophy on fees and costs (all eat away at gross returns), your willingness to look at new ideas, and how you will make decisions.

While you can take guidance from other investment philosophy statements, it is critically important to take a bespoke approach, resulting in a tailored philosophy that is right for your fund.

What is the risk of not having a clear investment philosophy?

Without a coherent investment philosophy you face the risk of lacking direction at the times you most need it. Chopping and changing strategies mid-flight in an effort to react on the fly risks locking in poor performance.

It will also expose you to the risks of making investments that don't really suit your goals, or even falling prey to those in the market who just want to sell you something.

A clear investment philosophy makes you very aware of what you really want to buy and helps you avoid the latest fad or distraction of passing unaligned opportunities.

How to develop an investment philosophy for your fund

Most institutional investors will generally have an investment philosophy, but often may not have it formally written down, or perhaps it is not written down in its entirety. Many investors will find their philosophy is due for a refresh given all the changes in regulation and the market environment in the last few years.

Or maybe you've never been sure your key stakeholders were all on the same page. If you have had changes in membership of your decision making body, then it's opportune to take the time (and it can take a lot of time) to sit down as a group and review it.

An investment philosophy does not have to be set in stone, and in fact, it's quite appropriate to review it periodically as the world is a dynamic place.

Sometimes what worked previously just doesn't work anymore, perhaps things didn't turn out as you wanted, or maybe your circumstances or the people you're investing for have changed.

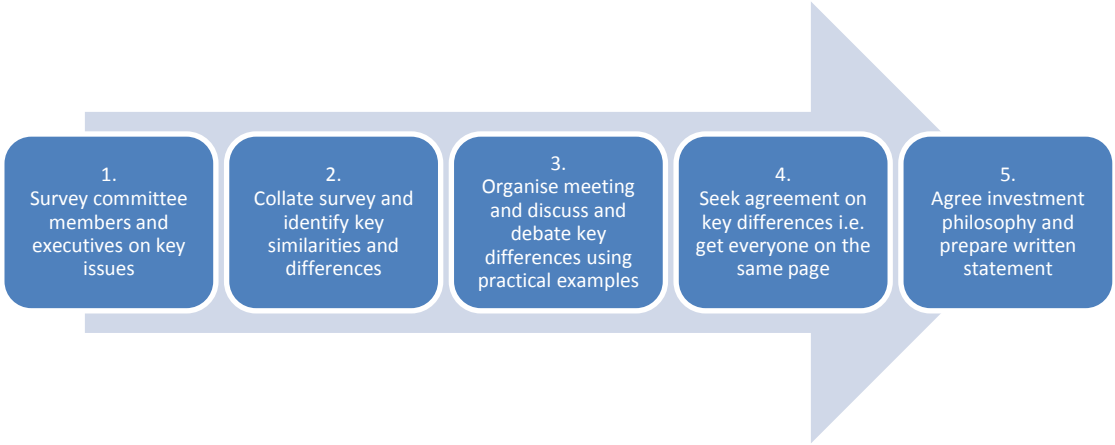
An investment philosophy review is best driven by the Chair of the fund. This emphasises to all how important it is and signals the need to create the time to review it fully. All members of the decision making body and key members of the executive should be involved.

An external facilitator can often be of assistance as, from a practical standpoint, someone needs to run the review process, manage the meetings, deal with any differences of opinion and seek consensus.

We find the process shown on the next page can be valuable. Step 4 is by far the hardest and can take a lot of time to resolve. It is important this is not allowed to slip too long as that essentially leaves the portfolio like a ship without a rudder.

If agreement cannot be found the Chair needs to step in and determine whether the disagreement is material and find a way to work through it. This can be a challenging process but well worth it.

Investment philosophy



In conclusion

Having a coherent written investment philosophy is critically important for any investor, and particularly so for investors with member-based decision making groups as it creates the backbone for the investment process and strategy, and the roadmap to return to when things aren't going as planned.

It also enables the key beliefs of the Fund to be transmitted among the membership of the decision making committee; particularly important when there is change in those members over time.

Frontier Advisors has many years of experience assisting clients develop their investment philosophies. To talk to us about helping you, please contact our Governance, Risk & Strategy team.

Combining a sensible investment philosophy with discipline and patience will maximise your chances of success.

FRONTIER ADVISORS

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About Frontier Advisors: Frontier Advisors is one of Australia's leading asset consultants. We offer a wide range of services and solutions to some of the nation's largest institutional investors including superannuation funds, government/sovereign wealth funds and universities. Our services range from asset allocation and portfolio configuration advice, through to fund manager research and rating, investment auditing and assurance, quantitative modelling and analysis, and general investment consulting advice. With around $160 billion in funds under advice we have been providing investment advice to clients since 1994. Our advice is fully independent of product, manager, or broker conflicts which means our focus is firmly on tailoring optimal solutions and opportunities for our clients. At Frontier, we're on your side.