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Managing the Client Mandate: Integration of Portfolio Investment Capture to the Investment Policy Statement Process

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Managing the Client Mandate

INTEGRATION OF PORTFOLIO INVESTMENT CAPTURE TO THE INVESTMENT POLICY STATEMENT PROCESS

By Bruce Stewart, CIMA®, CAIA®

This article introduces a risk–return metric called portfolio investment capture (PIC) that allows advisors to manage investment guidelines for clients objectively and pragmatically. PIC also provides a simple gauge to help clients self-advocate and assess whether their portfolio strategies have achieved the intended risk and return target. PIC allows advisors to clearly and concisely demonstrate whether portfolios have delivered the targeted investment results in terms of return as well as risk. The risk measure is predicated on what the client experiences in terms of risk, i.e., drawdown risk, not beta or standard deviation.

PIC can be used in the client investment policy statement (IPS) to integrate construction and measurement processes into the portfolio using a clear and quantitative format that most clients can understand regardless of their investment experience. Using PIC in developing the IPS puts the focus on "managing to the mandate, not the market." This is invaluable when clients want to chase the proverbial "hot dot" or make significant changes to their portfolio strategies during drawdown scenarios, e.g., March 2020. Managing client

expectations and maintaining portfolio discipline are clear dividends that PIC can add to an advisory relationship. Most importantly, PIC allows the advisor to demonstrate success or failure in portfolio design relative to client-stated objectives.

PIC incorporates behavioral finance into the IPS by blending cognitive psychological theory with conventional capital market theory, and the IPS is the centerpiece of a client's investment strategy; it is the main tool used to engage the client, and it also allows the client to self-advocate. Clients must be part of the PIC/IPS development process because they need to own it. This article begins with a foundational discussion of the importance of the IPS and a brief description of modern and post-modern portfolio theory, which are critical to understanding the role and value of PIC in the investment process.

IMPORTANCE OF A MEASURABLE IPS

The IPS communicates a client's investment goals and objectives and describes the strategy for managing the portfolio. There are, however, the good, the bad, and the ugly among IPSs (see table 1).

An IPS often begins by identifying broad investment objectives and risk descriptions, such as conservative, growth, or moderate. These subjective descriptions are then translated into various asset allocations based on standard deviation, correlation, and expected returns, attempting to translate qualitative interpretations of risk and return into statistical metrics that assume normality.

Within the modern portfolio theory (MPT) construct, assessing portfolio strategy and results is often a subjective and nontangible exercise between client and advisor. Much is left open to misinterpretation and misunderstanding, especially as it relates to reconciling client IPS objectives with actual portfolio results.

Ideally, an effective IPS incorporates two important and interrelated components: an outline of the client's quantitative and qualitative objectives; and a set of metrics for the accurate evaluation of the portfolio's targeted outcomes, including easily understood return and risk measures, not statistical measures.

From an implementation perspective, the IPS should be summarized as part

Table 1

INVESTMENT POLICY STATEMENTS

The Good	The Bad	The Ugly
• Provides appropriate guidance on portfolio construction, ongoing management, measurement, and frequency • Helps maintain focus on the client's mandate and assists in avoiding deviations due to changing market conditions • Serves as a critical tool in keeping clients focused on their stated objectives • Clear metrics of success and failure	• Written to satisfy compliance or regulatory requirements • Are vague and fail to be integrated into the advisory process • Provide no means of testing the success or effectiveness of the portfolio design relative to actual results • Lack of clarity around client risk-reward mandate	• Crafted in broad terms with the effect that similarly stated objectives can have drastically different interpretations from one client to another • Utilization of broad indexes and asset classes

of any portfolio review process to ensure the client has context for the portfolio's construct, performance, and risk.

An IPS document may be three to five pages in length, but a summary of its core elements should appear on each quarterly investment performance report. This summary reminds the client (and maybe the advisor) of the client's risk-reward objectives.

MODERN PORTFOLIO THEORY

The MPT framework assumes that returns, in general, are normally distributed and that capturing just two of the four moments of a return distribution, i.e., mean return and standard deviation, is sufficient in determining the risk view of a manager, asset class, or portfolio. Another broad metric of risk generally used in the MPT framework is standard deviation, or volatility without a perspective toward skewness or kurtosis, otherwise known as "tail risk." Volatility is the statistical measure of how much variation (i.e., noise) is around an average value or outcome. This idea that most outcomes over time occur around a central measure, with few outlying events, makes standard deviation useful. However, when investing in less-efficient asset classes (e.g., hedge funds) or within multi-asset class portfolios, it may present an incomplete picture of risk.

Further complicating this approach is the potential for mislabeling of investment strategies. Consider, for example, placing a master limited partnership (MLP) or real estate investment trust (REIT) strategy in the fixed income asset class because they deliver a bond-like income stream. But MLPs and REITs both have volatility, drawdown, and correlation features tied more closely to the broad equity market than the investment-grade fixed income markets. This kind of subjective classification often mischaracterizes the real risk of the fixed income asset class as well as each strategy. Assuming one asset class is more conservative than another without checking under the hood via a more

sophisticated factor analysis may lead to an incorrect assumption about risk or diversification.

From a behavioral perspective, client expectations and objectives change over time and their application to portfolio results and advisor performance can become misplaced. In the case of investment committees, the institutional memory of the IPS often is lost as committee members change, creating a scenario in which IPS "scope creep" becomes a challenge to manage.

An IPS that clearly defines success metrics for the portfolio, incorporates risk and return metrics, and is reported quarterly or at least semi-annually to the client, generally helps to manage client expectations and maintain portfolio discipline.

POST-MODERN PORTFOLIO THEORY

In contrast, post-modern portfolio theory (P-MPT) suggests that a more thorough and experience-based approach may be utilized in communicating a risk in a multi-asset class portfolio given the illiquidity that may permeate a more-complex strategy. Specifically, all moments of a return distribution (mean return, standard deviation, skewness, and kurtosis) are incorporated, and a non-normality of return distributions may be taken into consideration. Implicitly, the risk experience is best understood via a drawdown-based measurement whereby the frequency, depth, duration, and recovery time of loss are utilized, not solely a volatility metric.

This philosophy translates well when establishing an IPS for a portfolio built around experience-based metrics, because the client may relate more easily to acceptable return and loss ranges for different market scenarios.

Importantly, the same experience-based metrics utilized to construct the portfolio also are used to measure its success in

a simple, quantitative framework that removes human assessment bias. The Sharpe ratio has a role, but not in the context of a multi-asset class portfolio that incorporates illiquid strategies—mathematical civility must be balanced with a tangible assessment approach that clients can also understand.

UTILIZATION OF THE IPS WITHIN THE P-MPT FRAMEWORK

The IPS historically has been a relatively ubiquitous part of the portfolio construction process, and it is the cornerstone of this quantitative portfolio construction and measurement process as well. The following are some distinguishing characteristics of the IPS in the P-MPT environment:

The IPS is integrated into the portfolio construction process

- Multi-dimensional risk and performance factors are considered.
- Specific quantitative ranges are set for positive and negative market scenarios.
- Non-normality and illiquidity are considered.
- Full client participation and understanding are needed.
- Emphasis is on risk relative to drawdown loss.

The IPS is integrated into the portfolio monitoring and measurement process

- Risk and reward are coordinated into a success metric, PIC.
- Metrics of success and failure are established and simple to understand.
- Portfolio success metrics are measurable and not open to qualitative interpretation such as composite construction, peer groups, and statistical relevance.
- The IPS becomes an effective tool for the client to self-advocate.

Drawdown is a "pain threshold" concept. Drawdown loss measures the amount of capital lost over a period. Understanding drawdown is an important investment consideration because

recouping capital loss is difficult. Consider that if an account loses 75 percent of its capital, it needs to gain back 300 percent just to break even. When assessing risk, the frequency, depth, duration, and recovery time matter, and not just the average variation around the mean.

P-MPT suggests that a drawdown-based analysis best expresses the actual portfolio experience in up and down markets (i.e., what the investor experiences as opposed to statistical measures). A drawdown-based analysis is tangible, measurable, and considers illiquidity. It includes all four moments of a return distribution (mean return, variance, skewness, and kurtosis). The inclusion of kurtosis (tail risk) is paramount in developing a more thorough understanding of risk, especially in multi-asset class portfolios that include allocations to less efficient asset classes.

As we seek to distinguish between MPT and P-MPT by moving away from a focus on standard deviation, we instead focus on a drawdown-based analysis. An element we focus on in this drawdown-based analysis process is PIC.

PIC seeks to set relative target return ranges during rising and falling market scenarios. It incorporates risk and return consequences for a portfolio within a single measurement. Ideally, the measurement period would encompass a full-market cycle (defined by a peak to trough to peak or vice versa), but a rolling 12-month period may suffice. It may be utilized to set target ranges for a manager, asset class, or portfolio. It is composed of up-market capture and down-market capture.

PIC IMPLEMENTATION

Discussing PIC is an opportunity for the advisor to set realistic expectations with clients and invite them to take ownership of the risk they are seeking relative to the desired return. It is also an educational opportunity that may encourage active dialogue around asset allocation,

risk, and capital markets, which in turn affords the advisor an opportunity to build credibility within a consultative interaction.

Discussing and setting the PIC requires critical communication between the advisor and the client. Each must understand the other in order to determine the client's risk tolerance in terms of drawdown and to appropriately set the target return range. Equally important is testing whether the client's understanding of risk and reward is congruent with capital market reality (e.g., reality-checking a client who wants 100 percent of the up-market and 10 percent of the down-market).

The IPS up- and down-market target ranges will serve as the baseline test for all investment decisions. It effectively will serve as the litmus test for strategic allocations.

The IPS up- and down-market target ranges will serve as the baseline test for all investment decisions. It effectively will serve as the litmus test for strategic allocations. It may serve as a quantitative (as well as emotional) control point for investment decisions. The most common scenario would be a client reading headlines or speaking to friends about a smart manager or investment product that the client would like to add to the portfolio. However, this idea may not be consistent with the up- and down-market capture of the portfolio. PIC allows the advisor an opportunity to keep the portfolio consistently focused while managing to the mandate, not to market noise.

RANGE SETTING

Setting and building a collaborative set of ranges for both positive and negative market scenarios is the critical building

block in educating clients, setting reasonable expectations from a capital markets perspective, and reinforcing both risk and relative reward expectations. These ranges generally are determined using the following guideposts:

Positive-market capture. For every 10-percent return of the MSCI-All World Index, how much do you want your portfolio to capture: 60–80 percent of it, i.e., 6–8 percent for every 10-percent rise in the broad equity index?

Negative-market capture. Inversely, for every 10-percent loss of the MSCI-All World Index, how much are you willing to accept: 50–70 percent of it, or a loss of 5–7 percent for every 10-percent loss of the broad equity index?

Best practices may include reviewing and confirming these ranges regularly with clients so they have the proper context when reviewing their asset allocation and performance.

Once the PIC is agreed upon and added to the IPS, it would be regressed utilizing backtested or forward-looking data and built into a formal asset allocation, then reviewed periodically to ensure the portfolio is performing as expected. Generally, 12–18 months or a full-market cycle are ideal measurement durations for this approach.

An important caveat to remember: The positive and negative relative target ranges are not the same mathematical concept as the common up and down capture metric used by several analytics programs. Rather, it is the simple percentage of an index over time; e.g., a target 60–80-percent positive-market capture refers to targeting a 6–8-percent return for every 10-percent return in the broad equity market.

Historically, the most common target range scenarios have been 50–70-percent positive-market capture

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and a 30–50-percent negative-market capture while invested in a 50/30/20 (equity, fixed income, hedge fund) portfolio, which often translates into a 65/35 portfolio from a factor or risk-diversification type allocation.

On an annual basis, portfolio performance is measured relative to the client-targeted up- and down-market capture to ensure both returns and downside risk are within the acceptable and targeted ranges set forth in the IPS.

CONCLUSION
PIC effectively determines an outcome-based investment strategy that can be

measured and managed dynamically using a single measurement that both a sophisticated investment committee and a novice investor may understand. It compels the advisor and client to agree to a relative return-capture range congruent with the risk the client is willing to accept. Risk is defined by what the client would experience in a drawdown scenario as opposed to a statistical measure that doesn't directly express portfolio loss.

PIC can be an integral component of the IPS process because it removes any ambiguity or subjective interpretation around portfolio success. It is an easily utilized

metric that ensures adherence to the integrity of the IPS and comprehensively covers most risk factors. This attribute makes the IPS relevant and a tool for the client to use to self-advocate, as well as a mechanism that demonstrates an advisor's value from a portfolio construction and management perspective.

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