Art and science; Judgement calls increasingly complement mathematical models in asset allocation decisions

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The interview in this issue of the VBA Journaal is with Roger Urwin of the consultancy firm Towers Watson. Having worked in various positions at Towers Watson over the past 25 years, Mr. Urwin has an extensive experience working with institutional clients from different countries and has been involved in a wide range of investment issues, ranging from optimal asset allocation to ESG incorporation and governance. At Towers Watson, he was also one of the founders of the Thinking Ahead Group, an investment think tank trying to challenge the status quo and change investment for the better. Given the theme of this issue of the VBA Journaal, the editorial board thought that Mr. Urwin was positioned perfectly to share his view on how the profession of investment analyst is to evolve in the future.

Could you please introduce yourself?

I started as an actuary and went on to work as an investment consultant. I have also been active for the CFA Institute. I have been doing a lot of work in analysing various aspects of the investment industry, doing research on asset allocation and strategy, investment governance (helping board and investment organisations take their decisions as effectively as possible) and sustainability (which includes the environmental, social and governance characteristics of portfolios). I have spent time evaluating asset management companies on behalf of clients and conducting research on what makes investment managers successful. More recently I have found it interesting to evaluate how extra-financial information, such as carbon footprints and corporate governance, can be incorporated in investment analysis.

Koelewijn: Let's take a closer look at investment strategy at the level of asset allocation. Investment analysis is mainly about security analysis, and you mentioned the issue of asset allocation in your introduction. How would you rate the added value of investment analysis in the context of asset allocation?

Urwin: Many of the fundamentals in asset allocation are large-scale copies of analysis at an individual security level. You're dealing with groups of securities. In the case of, for example, global equities, if we deal with that as a broader asset class, it is about the ability to understand characteristics from a quantitative point of view to start with. For example, it concerns using methods, like the Gordon model of adding a yield to a sustainable element of growth in dividends, allowing for the level of distribution of dividends relative to earnings and making projections of the expected return over a cluster of securities. This needs to be referenced to different geographical groups and be considered in relation to expected GDP growth and the expected parameters of trading multiples.

Liquidity, transaction costs and governance considerations are all inputs for successful asset allocation decisions

Analysis of individual securities often will take the form of a dividend discount model and, what is being done there, is the equivalent of what is being done on a cluster of securities. Subsequently, that leads to the parameters that are the starting point of an asset allocation decision. Insofar as you're interested in a timeline, the methodology used when I started my investment career, has gradually become more 'softened'. Markowitz's principles of means-variance optimisation are still a factor, but the "art" of asset allocation is now taking into account other factors that are relevant to successful allocation. These factors include stock volatility, liquidity, transaction costs, estimated on-going costs of current investment vehicles and governance considerations, and are all input for making that decision. Including these factors, some of which have a quantitative element, has become increasingly common, and has made asset allocation an exercise of judgement, rather than being based purely on mathematical models.

Koelewijn: So you don't solely rely on mathematical models, but also use sound judgement as input for your asset allocation?

Urwin: Precisely. This shift has given more emphasis to the qualitative factors and less so to the quantitative models.

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Analysts have learned this over the decades through VBA and CFA qualifications.

Koelewijn: Often investment analysis is used to make tactical decisions. As you put it, it is rather used for the more strategic decisions concerning the absolute weight of equities or bonds in a portfolio. Is this type of analysis meaningful for tactical decisions as well?

Urwin: Yes, it is. Investors continue to think in terms of building their asset allocation out of three component portfolios: a reference, strategic and tactical portfolio. An investor may well be comfortable with an allocation to global equities, with a centre point of 45 per cent, with agreed limits of between 40 and 50 per cent. Their interpretation of the expected returns and valuations relative to their long-term, macro assumptions parameterises valuation provide tactical opportunity in relative terms. They can overweight their 45 per cent central position. The inputs here are quite quantitative, but most investment processes do not systematically map these inputs into a very clear output. I would tend to argue that the reliance on mean-variance optimisation was too high. It didn't allow for judgement to be included and was too singular and precise.

Koelewijn: In your view, does this kind of analysis have added value in terms of additional returns, or does it only lead to better decision-making? After all, the aim of tactical decisions is to outperform the market.

Urwin: This is similar to a manager who is tasked with outperforming the index at a security analysis level. The strategic task is to outperform the market. A reference portfolio is often set up to reference the amount of risk that a portfolio is meant to take. 60 percent equities and 40 percent bonds would be a quite standard reference portfolio. In the strategic and tactical portfolios, successful investment would be outperforming the reference portfolio over a reasonable period of time. By default, the portfolios are meant to have a similar level of risk. That makes the comparison particularly focus on the value-add in the decision, and the cost of that decision. It is slightly different than the security level in that respect. Most global equity portfolios carry similar absolute levels of risk to their benchmarks. I do a lot of work with the MSCI organisation, and the measurement of risk is something that has become an important input to these decisions. There are several different ways in which risk can be measured in this context. To put it on the line, the amounts of risk that investors take and how much they know about those risks mark out good investors. What they have difficulty with is that the quantification of risk has become quite an evolved practice. There are widely used tools to help with that process, based on repeating patterns of security and asset class returns. In addition, there is the concept of expected return, where there is much less statistical reliance and judgement calls become more critical.

Koelewijn: What are your views on the governance of investment processes and management?

Urwin: To define investment governance, I tend to differentiate between two types of investment funds. Large funds, such as ABP/APG and PFZW/PGGM, have an evolved governance structure, which has an investment board, a trustee board, the investment professionals headed by a chief investment officer and a considerable investment team. However, the investment universe, worth over 80 trillion dollars world-wide, consists of millions of smaller portfolios as well. These are run by potentially minimal investment teams, but have at least some sort of investment board, to give guidelines to investment managers. Those two types of funds are the polar points of the

Roger Urwin

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spectrum. It is worth observing that the smaller versions rarely find their task easy, because their composition is inevitably less competent with respect to investments than is optimal to understand all the investment parameters of their mission and goals. It is also very usual for pension funds to have trustee boards made up of members and interested parties. The challenge to invest well in these situations is considerable. These people do not have any investment qualifications. At the top end, the quality of the governance is adequate for the difficulty of the issues it deals with, and has become much like what takes place in the corporate sector itself. If you think about corporations and their corporate governance, there is a board, an executive team, etc. This sets a model that large pension funds can use.

Smaller pension fund boards rarely find their task easy, because their composition is inevitably less competent with respect to investments than is optimal

Koelewijn: Are you arguing for more professionals in the investment boards of pension funds?

Urwin: I am. Ideally, that should be the case, but in practice this varies by country.

Koelewijn: What, in your view, are the most important tasks of the trustee board? Where should their focus be?

Urwin: It is critical for trustees to determine first what are the appropriate parameters of risk for the portfolio. Portfolios can be managed from low risk to high risk. The parameterisation of risk and the associated performance targets are the highest level activity that the trustees can carry out. Secondly, the trustees are entrusted with decisions about delegating the investment process, usually to outside firms. These outside firms are a necessary part of managing the fund, because it is too complex to take on investment mandates without having outside professionals involved. From that point of view, the trustees can feel better about not having to take decisions that they feel are not suitable with regard to their own experience and background. The third part of the trustee role is to work out a way of operating. Governance is very introspective, it looks in on itself. It has to weigh up the way of operating that is most suitable, and check that the organisations that it has delegated to are doing the job properly. In those areas, clear analyst qualifications are not required. But they do require a degree of experience with what constitutes effective practice. If they don't have enough experience, they will be vulnerable to the systemic pressures of the industries, which are called agency issues. Many trustee boards have problems dealing with this, an issue of interest to pension regulators in the very firm regulated Dutch market. In this area, there is very much the pressure on larger funds to allocate their resources in line with sound governance principles.

Koelewijn: Is it not necessary to have personal qualifications to, for example, have discussions with other parties? My own experience is that people without these qualifications often get blown away by other parties with more knowledge, confidence and resources. How would you suggest that members of trustee boards are capable enough to enter these discussions and make an impact?

Urwin: The trustee board is a group of individuals, and what you seek in a group is not the same as the characteristics in every individual. What you need is a chair who is competent and can judge these situations on their merits, and that, when judged as a whole, the trustee group has the competencies it requires. The principle in governance is that it is the group that counts and you take a holistic view of the group's capabilities. You do, in those situations, need a means by which all individuals have the chance to contribute. That is the principle of diversity in dialogue, but unity in decisions. At the end of the day, the trustee group needs to decide on the course of action, but the inputs to that decision need to come from many individuals. Some of those may not necessarily be fully financially competent, but do have strong views about the institutional constraints and for example raise the point of sustainability. The sustainability issue comes up when funds may have some investment limitations, coming from what members wish to see in a responsible investing practice. You would not wish to see cluster munitions, etc.

Koelewijn: In practice, I observe that it is very difficult to make decisions that diverge from the chosen path, for example changing a manager. Investment professionals tend to keep their course. When looking for a new manager, they select one that has delivered a good performance over recent years, because it feels more comfortable and it easy to justify than selecting a manager that has had some bad years. Do you see this as a problem?

Urwin: This is the challenge of needing to be forward-looking but only having facts about the past. Investment is a very extreme activity, because it calls for decision-making about the very uncertain future, volatile markets, complex issues, and issues that cannot be called scientific facts, making them ambiguous. These four things are often referred to as an acronym, VUCA: Volatile, Uncertain, Complex and Ambiguous. This context makes individuals seek the confirmation of past facts, but they will very rarely find those facts particularly helpful to decision-making about the future. The classic difficulty in investing with respect to style is having a value style or a contrarian style. Governance is probably fundamentally backward-looking, but you can't blame the board for doing so.

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Koelewijn: How do you see non-financial information change the field of investment analysis?

Urwin: I call ESG (Environmental, Social and Governance) a very slow-moving but unstoppable train, which is having, or certainly is going to have, a very big impact on the investment field. Investors have to recognise that many risk factors and return drivers lie in these extra-financial factors. These factors could be in the supply chain, the value chain, in the carbon footprint, in a company's water practices, or in the way the human capital workforce is being dealt with.
Increasingly, for any investor who views a portfolio as a long-term holding, for 5, 10 or 15 years, these non-financial factors have become a bigger part of the success of corporations over time. It is really about the developments going on around the world with regard to energy, food, water and the environment. With limits to the growth of those particular natural capital sources, investors will be more successful if they take them into account. What I am promoting are the benefits of a long-term integrated approach to financial and non-financial factors. Alongside that change, there is a movement towards inclusive finance, which is having regard to the impacts of portfolios through externalities, spill-overs on the economic and social wellbeing of society. Stranded assets, for example, are currently a much debated issue; should we at all feel comfortable with investing in companies that have significant fuel reserves, like Shell and BP, when they are associated with high carbon emissions? Is that a factor investors should consider? Increasingly, a large number of investors is thinking about those questions afresh. They often decide that they should take a more inclusive approach, considering the consequences of their investment portfolio.

Koelewijn: A lot has been said about the quantitative easing policy of the ECB. Do you think markets are over-valued as a result of this policy?

Urwin: In my view, the market has got ahead of itself, and this is partly due to the supportive liquidity conditions that are at the outcome of quantitative easing and unprecedented monetary policy approaches, that is the values of assets have gone beyond their fundamental intrinsic values. Overvalued indexes do not necessarily mean that we should expect those values to revert in the near future. Interest rates are, I think, lower for longer.

Koelewijn: Is there anything else you would like to share with our readers?

Urwin: What I feel particularly strongly is that the successful investment analyst of the future does need to think much more deeply about the world in 10 or 20 years from now and how their activity connects with society. Those are new factors. Analysts 10 or 20 years ago did not need to do those two things.

Koelewijn: An analyst should not only think inside out, but also outside in?

Urwin: That's exactly right!