The role of investment philosophy in evaluating managers

Angela Ashton | PortfolioConstruction Forum | 06 May 2015 | 1.50 CPD

"The Role of Investment Philosophy in Evaluating Investment Managers" by John Minahan, Journal of Investing, Summer 2006
"Do institutional investors have sensible investment beliefs?" by Kees Koedijk & Alfred Slager, Rotman International Journal of Pension Management, Vol 2, Iss 1, Spring 2009

Investment philosophy is the oft-forgotten or under-valued part of a fund manager's investment process or style. Often, marketing teams find themselves charged with having to write it, resulting in generalist guff, regardless of the manager's asset class or style. For these reasons, many consultants and researchers tend to skip over statements of investment philosophy, as well.

Yet, in the opinion of a few well-credentialed analysts and academics, well thought out investment philosophies are investment gold, providing a lot of insight at a lot of levels.

Dr John Minehan, of MIT Sloan and a long time asset consultant in the US, is firmly in the camp that thinks a manager's investment philosophy is important. He argues that investment is hard - no-one really knows the true value of any security. The uncertainty about future cash flows and correct discount rates means asset valuation, and therefore beating the market, is difficult. So how does a manager outperform? The answer is that they need to have a view on why and how markets sometimes mis-price assets and how they can exploit this. They need to understand if this competitive advantage might be temporary and how they might change their process if necessary. They need to have a philosophy!

Many investment philosophies, however, don't cut the mustard. They may be something like: "currencies trend and these trading rules have worked in the past". Or, even worse, they could be something like the standard "we believe markets are inefficient" marketing catch-all.

Philosophies must be robust - according to Minehan, they must convey an understanding of how the manager adds value. Examples might include Vanguard's "minimising the cost of investing is vital for long-term investment success" or Warren Buffetts's simple, "Be greedy when everyone else is fearful".

For Kees Koedijk of Tilberg University in the Netherlands and Alfred Slager, CIO of Stork Pension Funds and researcher at Tilberg University, a good investment philosophy is the basis of a workable investment process. Everything investment-related should be feed back to the firm's investment process.

Koedijk and Slager believe that both fund managers and investors (they talk about super funds, but it could be any investor) should have an investment philosophy. For super funds, they believe it provides a framework for analysts to consider managers, to ensure that time is not wasted on inappropriate options.

They surveyed hundreds of super funds globally and found only 23 with published investment philosophies. However, those that had strongly stated beliefs about risk diversification were related to improved risk-return ratios, higher alphas and lower costs. But the sample is small, so the results can't be relied upon.

Unfortunately, there has been no in-depth research to look at the effect of good investment philosophies on performance. However, the idea that having a strong investment framework helps to provide structure and focus, as well as a basis on which to judge performance (both internally within an asset management firm and externally by, say, researchers) does sound eminently sensible.

Hopefully, everyone will begin to investment philosphies more seriously.

Read "The role of investment philosophy in evaluating investment managers"

Read "Do institutional investors have sensible investment beliefs?"