Russell London Monograph

The Four Golden Rules

Common Sense Principles for Winning the Active Management Game

Don Ezra

Monograph No. 7, February 1999
Frank Russell Company
6 Cork Street
London W1X 1PB
Tel: 0171 287 2858
Fax: 0171 414 0079
Website: www.russell.com

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Seven investment truths emerge from Russell's 30 years of investment experience. From these seven truths can be derived The Four Golden Rules for winning the active management game. They are: (1) Use specialist products; (2) Diversify manager research risk; (3) Diversify investment styles; and, (4) Rebalance to asset mix policy. All boringly straightforward and logical. However, their boring features have an attractive offsetting characteristic – they make money.

For 30 years Russell has researched managers, measured investment performance, advised on investment strategies and managed portfolios of managers. Our accumulated three decades of experience can be distilled into seven valuable observations. While there are no eternal truths in the investment business - these come close.

Seven Investment "Truths"

1. Managers make all kinds of bets: country bets, currency bets, sector bets, stock selection, interest rate anticipation, tactical asset allocation, and so on.
2. Every type of bet causes "tracking error", that is, some sort of deviation from the return that passive investing produces. In other words, every type of bet causes some risk.
3. Managers have different capabilities in different areas of investing.
4. Security selection is the type of bet that good managers seem to be able to win at, with moderate consistency. Every other type tends to produce risk without a consistent reward.
5. It takes a lot of work to find managers who are reasonably successful at security selection. (Russell has succeeded at this task.)
6. Successful managers do not stay successful forever. Sometimes their people move, sometimes they change their process, sometimes others catch up and negate whatever was their source of advantage.
7. Every manager has a natural approach to assembling portfolios. Telling a manager to do it differently for one client not only guarantees that that client's portfolio will be different, but the trouble involved in having to remember different rules will usually cause it to underperform relative to the manager's other portfolios.

Out of these seven observations, one can assemble a portfolio of managers that is likely to outperform a passively implemented asset allocation policy. Remarkable, but true and tested. More than that: one can actually construct a philosophy to guide the construction of that portfolio of managers.

Here's how. Just for fun, I'll call the tenets of the philosophy the Four Golden Rules.

The Four Golden Rules

You have to start with good research, of course. And a lot of it. That follows from Observation 5 (it's tough work). Russell employs fifty research analysts around the world who do nothing but research managers. The analysts don't have client service or new business responsibilities. They are full-time dedicated researchers. They look at managers around the world, and identify the ones most likely to add value to passive benchmarks. These are labelled "Hire".

At any time there are perhaps 300 investment products with the "Hire" tag. It's the products that are labelled "Hire", not the managers. For example, Manager X may be rated "Hire" for UK Equities, but not for

Global Bonds. This reflects Observation 3; that managers have different capabilities.

Interestingly, the average length of time for which a product retains the “Hire” rating is about three or four years. It’s tough to remain superior forever. That’s Observation 6.

Rule 1:Use Specialist Products

At this stage we can formulate the First Golden Rule: Use specialist products. And to increase the likelihood of success, they should be rated “Hire” by Russell.

Specialists rather than generalists, because no manager is good at everything – and why not hire the best? For the same reason, once a product loses its Russell “Hire” rating, replace it in the portfolio.[1]

As you might guess, despite Russell’s research strength a “Hire” rating is not infallible. Some “Hire” rated products fail to outperform their passive benchmarks. What should you do to reduce uncertainty? You diversify.

Rule 2: Diversify Manager Research Risk

So this is the Second Golden Rule: Use multiple managers to reduce the chance of a bad selection.

It really works. Russell actually analysed every one of its “Hire” rated product predictions over a ten-year period. Measured over a randomly chosen quarter, a randomly chosen product outperformed 55% of the time. Over a year, the success rate for the average product rose to 60%. Multiple products, assembled in a fund using the Golden Rules explained in this article, lifted the one-year success rate to 70%; and their ten-year success rate was 99%.[2]

Another message from this analysis is, of course, patience. The longer you follow these principles, the more likely you are to succeed.

At this stage you have a number of good managers, all good at security selection. (That’s because of Observation 4: this is the most reliable way to add value.) But you remember (Observation 1) that even these good managers do things other than security selection, and (Observation 2) that’s risky, and (Observation 4) the risks won’t make money for you.[3]

Easy! Tell them not to take any risks other than security selection.

Can’t! Observation 7 says that if you tell them to do something unusual, even their normal money-making bets will suffer.

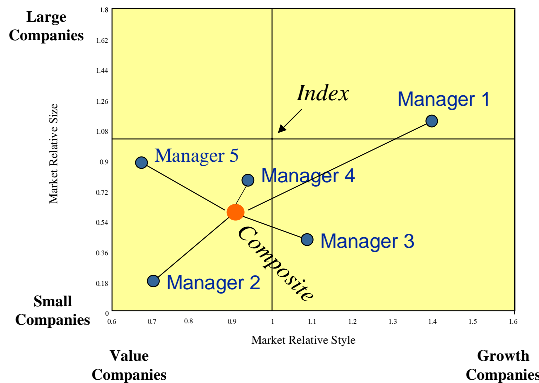
Rule 3: Diversify Investment Styles

It’s not obvious what to do now. Many years of experience have led Russell to the Third Golden Rule: Diversify across investment approaches.[4]

You need the tools to analyse their investment approaches. Exhibit 1 shows an analysis of where five UK equity managers picked by one investor had their normal habitats. Thus Manager 1 usually invests in large companies with consistent growth.

Manager 2 usually invests in small companies that are attractively priced relative to their book value. And so on. A portfolio with all five chosen managers in equal proportions would have an average habitat indicated by the composite dot, permanently biased towards small value-oriented companies. This would have been very successful in 1989. It would have been a disaster in 1998. And no one is good at predicting which area will do best in the future (Observation 4). The only way to be sure that you are invested in the winning part of the market is to be invested in all parts of it. That’s how you neutralise the risk of trying to guess which narrow area (or country, sector, or currency) to be in.

Style Biases of Five UK Equity Managers **Exhibit 1**



How do you do that? Move the red dot towards the cross hairs, which show where the market index lies. With the managers in Exhibit 1, give more money to Manager 1 and less to Manager 2. Or find an additional manager in the Large Growth quadrant.

This is called "manager structure". It has nothing to do with thinking Manager 1 is better than Manager 2. It has everything to do with neutralising all bets other than security selection, which is what you're trying to achieve.

You might ask: by neutralising all these other bets, won't I also neutralise the security selection bets? Then I'll have something close to an index fund, while paying for active management – a sure loser.

Well, you might end up there if you use any approach other than looking at habitats. Look at Exhibit 1 again. Only Manager 1 selects from Large Growth companies. Using the other managers won't neutralise these security selection bets. Nor will the other managers neutralise Manager 3's Small Growth company selections. There will be some overlap, and some neutralisation, of the securities selected by Managers 2, 4 and 5. Don't have too many managers in the same habitat.[5]

In this way you can assemble a portfolio of managers for each asset class (domestic equities, foreign equities, bonds, and so on).

Rule 4: Rebalance to Asset Mix Policy

I'm assuming that you already have an asset allocation policy selected.[6] Simply assemble your asset class portfolios in the proportions dictated by your asset allocation policy, and you're ready to face the world.

What should you do when market movements take your carefully constructed portfolio away from its allocation? That's easy. Observation 4 says that it's futile to decide which markets are overvalued and which ones are undervalued. Just rebalance back to your policy.[7]

And that's the Fourth Golden Rule: After you have diversified comfortably across asset classes, then stick to your most comfortable allocation.

Wrap-Up

That's it - all pretty straightforward and logical. But think what you've done. You've selected a comfortable asset allocation policy. You are going to stick with it rather than timing between markets. Your portfolio is a complex of managers, but essentially you only permit security selection. How *boring!* Look at the glamour you're giving up. None of "I'm selling the dollar." Or "I'm buying into Japanese weakness." (As if your actions determine the course of the world!)

But if you're interested in making money through active management – it works.

Notes

1. One of Russell's ratings is "Retain". Many clients don't eliminate a product from their portfolio if the rating drops from "Hire" to "Retain", judging that the cost of the change could exceed the benefit from the higher rating.

2. To date no consultant but Russell has been prepared to share its analysis of its own predictions and therefore acknowledge its fallibility. See Ezra D., "Adding Value through Active Manager Selection and Structure:

Documenting Russell's Experience", *Russell London Monograph*, No. 3, August 1998.

3. It shouldn't be a surprise that, in our experience, managers add value most consistently through security selection.

   One reason is that this is what analysts are trained to do, first and foremost. Much of their training focuses on analysing companies, and understanding how companies are valued relative to the market. These are precisely the skills involved in stock selection.

   The other reason is that any portfolio contains more "bets" in the form of security selection than of any other kind. Skill reveals itself most consistently when it is subject to multiple tests. Thus TAA, with perhaps one or two changes in direction a year, shows high tracking error relatively to passivity, whereas security selection, with perhaps 100 bets a year, reveals skill patterns in a much shorter time.

4. Investment approaches are often called "styles" or "habitats". Same thing.

5. Some commentators recommend a structure called "core plus satellite". This is intuitively appealing, but not when one analyses its consequences.

   Their "core" in each asset class is essentially an index fund. Their "satellite" in each asset class is essentially a specialist manager.

   Here's the appeal: the specialist (selected on the basis of good research) will make you money, while the core reduces your tracking error. Each part appeals. But each part has an unfortunate drawback.

   Yes, a well-selected specialist should make you money. But if you have only one specialist in an asset class, your selection may be as fallible as the research. Far better to diversify your selections. If a single specialist has a habitat that differs from the benchmark, then you've made a permanent bet that one part of the market will be a permanent winner. That's a bet that simply increases risk, without a commensurate payoff.

   Actually, that's precisely why advocates introduce the passive core. The single manager type of satellite is too risky. It has too much tracking error. A passive core reduces the tracking error. But at what a cost! If, say, half the exposure is passive, then only half your money is working actively.

   Far better to reduce the tracking error by neutralising all forms of risk other than security selection. And then let all your assets work actively for you.

6. Without an asset allocation policy, you are rudderless on the investment seas. Go back to your harbour and select one that you find comfortable. Don't even think of anything else until you do that.

7. Rebalancing is a subject worthy of separate discussion.