# The PODfolio Podcast – Season 2, Episode 7: Skill vs luck – a new way of assessing performance

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TIM HODGSON: And if you're going through a period where it's very positive and strong for returns, I would suggest that's a danger sign that it will probably then start to contract. And if a manager is reliant on it, it'll hurt their future return.

MARISA HALL: Welcome to The PODfolio, WTW's investment podcast series aimed at institutional investors, industry professionals, and enthusiasts alike.

LOK MA: Hello. And welcome to The PODfolio podcast. We're on episode seven of the second season already, wow. I am your host, Lok Ma. And today we're once again talking to the Thinking Ahead Institute. The not-for-profit research and innovation hub with representation from 60 or so investment organizations across the world. And we've actually got the two co heads of Thinking Ahead with us today. You should recognize the voice of our first guest. Marisa Hall, welcome to the show.

MARISA HALL: Oh, pleasure to be here.

LOK MA: Marisa continues the proud tradition of being a guest on the show after recording the intro that you listeners hear at the beginning of the episode. So, thank you, thank you. And we also have Tim Hodgson, the other joint head of Thinking Ahead. Welcome to the show, Tim.

TIM HODGSON: Great to be with you, Lok. Thanks for having me.

LOK MA: Our topic today, fundamental return attribution. I think I need to just hype this up a little bit before we start because it strikes me that this new approach for measuring investment performance has the potential of being a big deal, in quotation marks, in the investment industry.

As, I think, the intention, the ambition, if you like, is really to replace some of the performance measurements that we've seen for asset managers. Like, comparing against a market benchmark or breaking things down into styles, like growth versus value, and so on.

So, if that succeeds, then it is very much a big deal. Changes how you assess the work of the asset managers ultimately can feed into whether you hire or fire some of these managers. Tim, perhaps if I come to you first, why do you want to change how we look at performance, and also why now?

TIM HODGSON: Thanks, Lok. We've kind of always wanted to change how we look at performance, certainly. If I go back into pre-history when I was much, much younger than today, the Thinking Ahead group talked about long-term absolute return mandates. And we suggested a balanced scorecard was necessary to assess those long-term mandates.

The scorecard was based on work of Kaplan, and what have you. And it's fair to say that we didn't have a huge amount of success with the balanced scorecard. It was quite a lot of effort, and eventually that effort meant that people reverted to looking at the performance alone.

So in a sense, this is a continuation of the quest. It's kind of a new thinking, new approach. But we've always wanted to find a way to extract signal from noise. And that's kind of what the manager research effort is trying to do.

They're trying to form an independent view of the likely success of a manager not based on an extrapolation of past performance; ie what's the real underlying driver as to why you might expect success.

So I've kind of touched on signal versus noise there. We wanted to try and achieve that. We had done a lot of work within the Institute on long horizon investing. And we concluded and we published a paper claiming that there was such a thing as the long-term premium.

And it's really quite a chunky premium, somewhere between half and one and 1/2 percent per annum. So really worth harvesting. But a premium of that size can only exist if it's really, really hard to harvest or isn't really being harvested by anyone.

So we did a whole bunch of research looking at various angles, and it turns out that most people kind of sell out of stocks, or sack asset managers, when performance dips. And, not always but a lot of times, performance rebounds, and you miss out on that.

So a lot of work from CAPS and WM performance measurement companies, by academics Goyal and Wahal in the US, and we kind of wrote a paper on hiring and firing managers probably about 2006, 2007 where there seemed to be, on average, a tendency to get rid of underperforming managers;

to hire a manager who had performed well but the track record wasn't in your portfolio; and roll the clock forward another three years, and results were disappointing. The manager you fired, performance recovered, the manager you hired was kind of flat. And so how could we find a way?

So that's the "why?". We wanted a mechanism to help asset owners stick with skilled asset managers even if short-term performance was poor. Now the second question I think you asked me was, "why now?".

Why now? In a sense I don't have a very good answer for you, Lok, other than we've developed our new thinking, and it's available, and we'd like to tell people about it. But we can be maybe a little bit more helpful than that. And I'll get to that.

But in terms of what the methodology is doing, is it's attributing the performance amongst three factors. Factor one is a growth return. So is the manager able to identify good companies that compound value for investors? Do they earn a return higher than their weighted average cost of capital? And that compounds up.

Secondly, how is the active manager at trading? And I don't mean we're accusing managers of short term trading, but they're always adjusting their portfolios through time. They're trimming positions, they're adding to positions, they're selling out of ideas, they're establishing positions in new companies. And essentially we can work out how they are doing that and whether that is accreting value for return.

And then the third factor is down to what the market is doing. Is the market attaching a higher valuation multiple to the companies in the portfolio? Or is it attaching a lower valuation multiple? So is your return being boosted because these stocks are getting more popular? Is your return being depressed because these stocks are falling out of favor?

And so we would argue that we're kind of pushing the signal into the first two factors and concentrating the noise, in a sense, in the last factor-- and I'm sure Marisa will talk much more about that. The last

thing, if I may-- and apologies if I've gone on too long-- why now? I am concerned, I think, and the work of the Institute is we are going to go through a significant transition.

We're either going to transition the economy to net zero. And that's a really big deal, properly understood. Or we're not going to do enough on the economy, and we're going to see the climate transition to a much hotter state.

In either case, I think that we're going to see much more volatility in that transition. Either because we're going to see worse physical climate impacts or because we're changing the structure in the relationships in our economy. So the fact that performance may jump around a lot more, we hope that this tool can help anchor people into what's going well and what's not.

LOK MA: Thank you very much, Tim. So the overarching idea separating signal from noise in the performance. And you mentioned that maybe it helps some institutional investors, I guess, in some circumstances, hold their nerve. If performance hasn't been great, at least you can attribute that performance to whether it's down to bad luck or bad judgment.

I understand the idea that looking ahead if there's more volatility to come, then you really want to make sure you've got managers who bring the skill rather than historic luck into your portfolio. So I've spent a bit of time researching this topic, like a good little podcast host.

As I've been on the Thinking Ahead Institute website, I've read the high level summary, I've watched the three minute video starring you Tim. I've even read the long detailed technical paper. And I think-- thank you.

And for me I think the best way of getting across what the fundamental return attribution framework does is to almost go through an example. So I think you've both come prepared. We're going to look at the performance of a hypothetical asset manager, and try to break their performance down into the three components that Tim mentioned. So, Marisa, do you want to introduce to us this asset manager, please.

MARISA HALL: Gosh, I almost feel like if I should give the asset manager a name. But I'll refrain from doing that. And--

LOK MA: Manager X.

MARISA HALL: Manager X, so that famous manager. And actually well done for getting through all of the material, I mean, that three minute video on our website, I'd highly recommend. It's definitely a good crib sheet. And for those of you who have braved the technical paper, well if you love math, you're going to love it. If you don't, then actually there's some good news.

The good news is that I think this is actually an intuitively simple concept. And Tim talked about it before. Effectively if you think about a manager's holdings, what we're really trying to do is break out this, what is the intrinsic value of the holdings versus what are the changes in market sentiment. So separating, as Tim said, what's in the manager's control with what's outside of the manager's control.

And what we do is we do this through the three factors. So we talk about changes in fundamental values, so that's the growth element of it; changes in activity, so that's thinking about rebalancing, thinking about what managers do, which is sell high and buy low, hopefully; and thinking about those changes in the market sentiment. So thinking about things like the valuations and the price to book ratios, and so forth. And obviously all of this with the ultimate aim of assessing the manager's decisions, not just looking at the outcomes. And we can see, if we think about this hypothetical manager X, how all three of these different features interact with each other.

You can see an example of a manager right up front buying an asset that is expensive. And they would really only do that if they thought that there was going to be this growth in fundamentals. That if they had that expectation that actually I've bought something, it is expensive but the future growth will become realized.

And you can also see how market sentiment could change all of that or market sentiment can affect that. And so actually we do see these three different ways of breaking down a manager's performance as highly connected, highly interactive.

So let's go back to your manager X, 10% performance. Just to make this a little bit more grounded, let's talk about what we often see in the investment industry. Thinking about buy and hold managers. So those guys that really just define a really good stock. They think about it, they think, oh gosh, the fundamentals are going to be great. And they hold on to it, and let's see what happens.

And let's think about another manager where they're actually thinking, well, we're going to quarterly rebalance. We're going to lock in, we're going to adjust it back to our stated benchmark, we're going to make sure that the portfolio is consistent with what we set it out to be.

And you can see with the buy and hold manager, actually, the return that's going to be attributed to this activity is going to be nothing, because they're holding it. So they're not trading it, they're not moving it up and down.

So what we would expect that that activity return is to pretty much be zero. Compare that to the quarterly rebalancing manager where we should see some changes, some hopefully positive returns from that activity element.

And then we think about things like, well, actually, let's think about the growth in that portfolio, in the two different portfolios. So with the buy and hold manager, what we would see is if you're not rebalancing, the stocks that are doing well will end up becoming those that you can attribute a greater weight to in the portfolio. They just kind of drift upwards because they're doing well.

And so what we would expect to see in our hypothetical example, for instance, is that for this buy and hold manager, a lot of that 10% return, or at least much more than the quarterly rebalancing manager, would be because, actually, they held those stocks. And, actually, they've kind of become a bit more, ... they've gone up in their weightings in the portfolio.

So they get to benefit from the growth in those fundamental factors because of it. And then finally changes in market sentiment. Well, actually, as your stocks take up a greater weighting in your portfolio, actually, then the market sentiment has a bit more of an effect.

So what's the summary of all of this? Effectively what we've had is we've got two managers, manager X, and let's call the new manager, manager Y, who are following two different strategies. They may end up with similar returns at the end of it.

But actually what we're able to see is how, for each one of them, their returns are broken down into, well, how much of it is due to rebalancing; how much of it is due to that growth in underlying fundamentals; and how much of it is due to changes in market sentiment. And that's really, really powerful because then you're able to really understand what's going on behind the box.

TIM HODGSON: Marisa and I have both talked about this market sentiment thing. And just listening to both of us, I think the one thing that neither of us have probably mentioned is that we believe that market sentiment, this valuation multiple, will mean revert over the long-term around the kind of average level.

So in other words, if you're going through a period where it's very positive and strong for returns, I would suggest that's a danger sign, that it will probably then start to contract. And if a manager is reliant on it, it will hurt their future return. Likewise, if the sentiment return has been hurting the manager for the last X years, then that might actually be a good sign because the fundamentals are cheaper to buy now, and it should revert back. So we would expect this market multiple factor, this valuation factor, this sentiment factor, to mean revert around zero. But it can stray from that and trend for a long period of time.

MARISA HALL: I think that's a really great point. And we say in the paper, in the short term we expect portfolio's returns to be dominated by this market sentiment. But, actually, if we think over the long-term, we're really looking at those changes in intrinsic value. So, yeah, definitely great.

LOK MA: So, I mean, to summarize that. You've got manager X, manager Y, different managers, different strategies, whatnot. Let's say both of them delivered 10% a year. So you're thinking actually, how much of that is down to factors one and two, which is more the skill-based stuff. And how much is down to factor three, which is the more market-driven, sentiment driven-stuff.

So I think that would be a very useful comparison to see which one of these are going to deliver long-term. And we're not, as you say, Marisa, we're not going to go into the technicalities in this podcast of how exactly that analysis is carried out, how the calculations are done, et cetera, et cetera.

The technical paper on the website does set out all of this in much greater details. There are mathematical symbols and equations in there. As you say, Marisa, I recognize the logarithmic function, there's this one Greek letter that I could recognize.

Some of our listeners are going to hear that and they're going to feel an absolute urge to look at that paper straightaway, good for you. Others will be very happy to understand the principles as we've talked about just now here.

So you've done the technical analysis. And let's go back to managers X and Y. Let's say they got the same return or similar return. But more of the return for manager X, say, is attributed to the skill-based, the, I guess, the fundamental growth and the activity trading-based factors.

And less of that is attributed to the market multiple factor, compared to manager Y. Chances are manager X is therefore better placed to deliver good performance in the future. Is that how you envisage, Marisa, how people would apply this framework in practice?

MARISA HALL: I think what's really important is when you're hiring a manager, understanding what you're getting into. So what is their philosophy, how do they view the portfolio, how do they believe they're going to be able to deliver those returns to meet what their stated target is.

And what we're trying to do here is not necessarily say this manager A's philosophy is good or bad. What we're trying to do is, well, actually, is the manager doing what they said they would do on the tin. You know, does it align with what they said they were going to do. And I think that's really important.

And we see this actually, and it's worth bringing in a sustainability ESG lens into this because actually we see this tool as potentially being very powerful in this space. So, one, we know that actually you can influence returns because of stewardship. And we would expect to see that good activity being reflective in that organic growth, growth in fundamental factors.

And, two, actually, think about how exciting it could be if we were able to apply this methodology to thinking about an ESG portfolio. Thinking about, well, is it because the emissions for a particular company is declining over time or is it because the manager has just traded, for instance, a high emission company

to a low emission company. And how does that compare with what the manager said they were going to do?

So I think what we do is we see the applications of this research across very relevant spaces that all of the industry is tackling right now. And so that's really at the crux of the basis of the research. And then if Tim wants to jump in.

TIM HODGSON: Yeah, no, I'd love to build on what you've just said, Marisa. Because I think anybody listening to my earlier rant about sentiment mean reverting through time might conclude that I'm biased against the kind of market multiple factor. But, Marisa, very, very clearly set out-- and I think it's brilliant and is worth emphasizing-- what did the manager say that they would do for you.

If manager X said up front at the point of hiring, our skill is to spot unloved companies, and discover them early. And when everybody else discovers them, you get this massive pop because their market multiple goes up. Then actually manager X is delivering to expectations.

Just "yes, and" to what Marisa was saying. This attribution allows, at core, a better understanding of how the return has been delivered, what are the components, how does it come about, and does that give you confidence to retain the manager at this point in time.

LOK MA: Fine. And as Marisa said, there's potentially more different ways of applying this research across different areas. So we've talked about the straight up manager research. You delivered x%, how much is that broken down two different factors? You also mentioned potential applications in the context of ESG as well, which seems to be a slightly different context.

Can we just take a step back then. So I know that the underlying calculations behind the fundamental attribution framework has been coded up by your team. So in terms of next steps, maybe turning to Tim, can you just tell us a bit about what you're doing with this methodology, and the coding for the calculations that your team have created.

TIM HODGSON: The short answer to that, Lok, is we're making it publicly available, for free. So if anybody is familiar with code, then they'll know about GitHub, github.com. It's not my natural space for going, when I visit the internet, but some people do.

And so the source code and other stuff is available to download, with the papers and the downloadable code. You need to supply your own portfolio holdings. But hopefully we've made it very, very easy for people to get going quickly.

So we'd love asset owners who might be listening to this to ask their asset managers, "do you know about this?" "Can you report this way for us and we'll see if we like it?". We'd love asset managers, if you're listening, to go and have a read, have a play, and see whether it's valuable.

So we worked with a small number of Institute members in the development of this. So it's testing the thinking, Beta testing it, they testing it against their portfolios. And so we know that WTW are already using it on various portfolios. And all of the feedback we've got so far is that the people who have tried it are finding it very valuable, in terms of the quality of the conversation, the richness of the understanding. And so you were great at the beginning, Lok. You said, open quotes, "big deal." I'm hoping you don't close the quotes after big, I hope you wait until 'deal' is out before we close the quotes. We would love to see this widely adopted. And that's why we're talking to you, we're talking to anybody who'll listen. It's all free, it's all available, it's downloadable. We'd love people to have a look and have a try.

LOK MA: And I also wonder if another angle is that by making this code more widely available, you might find that somebody out there thinks of a really cool way of applying this method that no one else currently has thought of.

TIM HODGSON: Oh, I think unquestionably the advantage of open sourcing something rather than us trying to protect it, and commercialize it, and what have you, is that the more eyes that are on this and the more people who tinker, the more chance you have of innovations popping up.

MARISA HALL: And I think that's what the Institute is really about. And we're so proud of the kind of research done by the team and for the members who helped us develop this research. You know, what are we really trying to do? We're trying to change the investment industry to really influence thinking. And at the end of this year, Tim made an appeal to asset owners.

If all you do at your next trustee meeting is say, actually, dear manager, please, can you break down this performance and let me know how much of that is due to fundamentals, how much of that is due to your rebalancing activity, and how much is just due to market sentiment. Then I think that's a successful conversation. So let's keep it going. Let's start shaking up the industry because, actually, that's what we're here to do.

LOK MA: So a new way of measuring performance that can separate out skill and sound judgment from the capriciousness of the market, of course, I looked that word up, and just blind luck. And the underlying calculations for this approach to be released as an open source, piece of code for everybody to use.

So I hope our listeners are feeling a frisson of excitement-- I'm full of the words today-- a frisson of excitement about the potential for changing the investment industry. Which, of course, is one of the main goals of the Thinking Ahead Institute. So thank you so much to both of our guests. Tim, very much appreciate your time.

TIM HODGSON: Thanks, Lok. It's been great.

LOK MA: And, Marisa, thank you for coming on too.

MARISA HALL: So great to be here. Thanks, Lok. And good luck with the dictionary words that you can think.

LOK MA: Thank you. And until next time, to our listeners, do take care.

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