Anchors Aweigh!
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“Nothing in life is as important as you think it is, while you are thinking about it.”

Daniel Kahneman, Thinking, Fast and Slow

One of the most important decisions that an investor makes is the choice of benchmark used to represent the investment outcome that they are seeking to achieve. For passive investors, the link is direct. With a wide range of exchange traded funds and other tracking funds, it is possible to construct a portfolio that closely reflects the desired benchmark less costs. For active investors using the services of a discretionary investment manager, the benchmark is typically used to inform the process of setting investment guidelines and serves as both a “neutral” asset allocation and a performance target. The manager then seeks to deliver performance over and above the benchmark through a combination of tactical asset allocation and superior fund/stock selection.

In behavioural science, the “anchoring bias” refers to the tendency to rely too heavily on the first piece of information offered. Benchmarks can act as a powerful anchor, constraining both the expectations of the client and the actions taken by a discretionary investment manager. This article examines the potential impact.

**Anchoring Risk**

The degree of discretion employed by private client and charity discretionary investment managers varies significantly but there is one factor that remains constant: the choice of benchmark is a significant factor in determining the performance outcome for a portfolio, both on an absolute and on a relative basis. Why might that be? Because one of the risks that discretionary investment managers both monitor and seek to control is the divergence of a portfolio both in terms of asset allocation and performance from its benchmark.

Consequently, anchoring to a benchmark introduces its own risks into the investment process: the risk that the benchmark does not adequately represent the desired investment outcome; the risk that the full universe of investment opportunities is not addressed; and the risk that investment decision making is unduly constrained.

To examine the impact of the anchoring bias, we have considered potential outcomes for a portfolio with a risk budget of around 0.7 times that of equities. Such a portfolio would sit in the middle of the ARC Steady Growth universe of portfolios which encompasses those with a realised volatility versus equities of 0.6 to 0.8 times. The analysis has examined the impact of anchoring bias by examining two components: the impact of tactical asset allocation and the impact of adding fund/stock selection into the mix.

To analyse the impact of tactical asset allocation, the starting point was to select a benchmark. The ARC Sterling Steady Growth Reference Index has been used to approximate the asset allocation and behavioural pattern of typical portfolios in the ARC Steady Growth universe. An index tracking strategy would merely hold index-tracking vehicles in these prescribed percentages and deliver the benchmark return (less costs). However, most discretionary investment managers employ tactical asset allocation to seek to outperform the benchmark. Thus, permitted ranges have been set for each asset class.

The table below provides the investment guidelines for a Steady Growth portfolio in Sterling. The next step is to run as series of simulations to see how the risk and return profile of a discretionary portfolio with these initial conditions might behave.
The results are set out in the chart and table below. The simulated outcomes are shown as black dots, together with the ARC PCI peer group indices and global; US and UK equity markets for the three years to 31 March 2018. The shaded region represents a simplified opportunity set based on combining cash with US and UK Equities and the reference portfolios illustrate the outcome of a portfolio comprising one-third cash and two-third equities.

Although active tactical asset allocation means that there are a range of expected outcomes for the portfolios, it is noticeable that for any given risk level, the blue wedge is much wider than the simulated outcomes represented by the black dots. With UK Equities significantly underperforming US Equities over the past three years, the extent to which investors are satisfied with their portfolio performance versus a peer group of portfolios with similar risk characteristics will be very sensitive to the weighting of UK equities and US equities in their respective benchmarks. In summary, the higher the benchmark weighting to US equities, the higher the return a portfolio is likely to have experienced.

While extreme, it is possible for a Sterling reference currency portfolio to have enjoyed 3 year returns almost 12 percentage points higher than the ARC Sterling Steady Growth Reference Index through investing the equity element only in the US. Similarly, a Sterling portfolio that invested the equity element purely in UK equities would have been circa 4 percentage points worse off.

The results highlight very clearly the anchoring risk associated with choosing a benchmark. Although a manager may outperform their benchmark, portfolio performance may be well below that which would have been possible with the same risk budget but a different benchmark. The smaller the tactical asset allocation ranges likely to be deployed by a manager, the greater the anchoring risk inherent in that portfolio structure and the more time should be spent considering the future expected returns from the various benchmark components.
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The next stage is to analyse how the range of outcomes might increase when both tactical asset allocation and active fund/stock selection is permitted. To give a sense of the range of outcomes possible from a risk budget of around 0.7 times equity risk, outcomes from the ARC Steady Growth PCI can be examined.

The chart on the left shows a sample of 500 Steady Growth portfolios (the black dots) from the Sterling PCI Universe. The results show a far greater range of outcomes than was the case when only tactical asset allocation was permitted, demonstrating the greater dispersion of outcomes created by the active fund/stock selection undertaken by managers. Further, a few outcomes lie outside the opportunity set illustrated by the shaded region, showing the ability of managers to add value beyond that delivered by selecting a strategic benchmark and then undertaking solely tactical asset allocation activities.

It is a reasonable assumption, based on the evidence, that a portfolio that had a benchmark (strategic asset allocation) heavily oriented towards US equity would almost certainly have delivered top quartile returns versus the peer group. By contrast, a Sterling denominated portfolio that had a benchmark with significant UK equity exposure would have struggled to move outside of the bottom quartile.

Conclusions

Benchmarks provide valuable information to both private clients and discretionary managers in providing a reference point for the potential performance characteristics of a portfolio. However, benchmarks act as an anchor that may implicitly or explicitly restrict the range of opportunities available to clients. Here are four observations:

- When setting a benchmark, it should be constructed to reflect the major sources of potential risk and return to which the client wishes their portfolio to be exposed. If the benchmark does not reflect the “neutral” asset allocation, it will be less useful.
- Care should be taken when setting asset allocation ranges that they do not unduly restrict the available investment universe or the ability of the manager to express their investment convictions through tactical asset allocation. If the ranges are too wide, they can be as ineffectual as when they are too tight.
- Active fund/stock selection widens the range of potential outcomes and allows discretionary managers to compensate for inherent risks embedded in indices.
- Using the relevant ARC PCI in conjunction with a benchmark allows private clients to assess performance against their peers as well as versus their “neutral” asset allocation. Both comparisons provide helpful information.

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