

WHAT TO LOOK FOR IN YOUR QUARTERLY REPORTS

By Robert Brown

Investment managers generally report to their clients at quarterly intervals and these reports have two main functions.

In the first place, they are the "document of record" in which the manager itemises all the capital and income account movements over the period in question and values the portfolio as at the reporting date.

Secondly, they are the document in which the manager explains the investment policy which is being pursued and reports on the success or otherwise of this policy.

To the extent that the reports are a document of record, their content is dictated largely by regulatory requirements. To the extent that the reports are a commentary on investment policy, the manager is free to choose the content subject to any special supplementary requirements which may have been specified by the client.

Investment managers' reports vary a great deal in content and in quality.

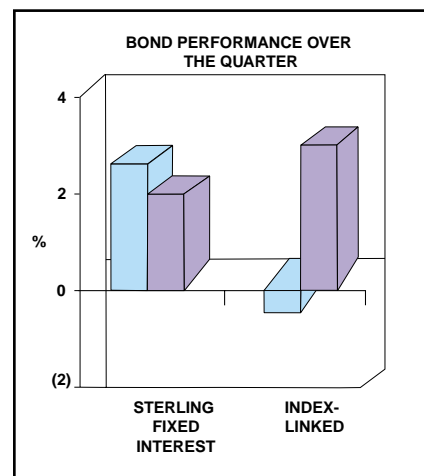
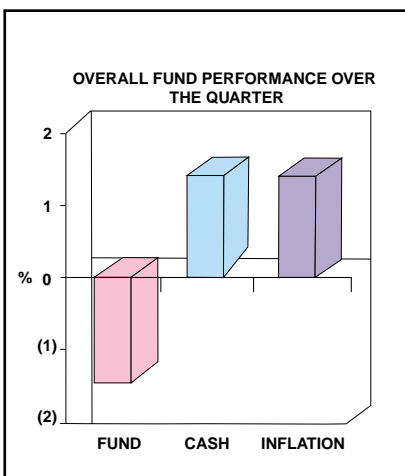
Generally speaking, to the extent that a quarterly report fulfils the functions of a document of record, its accounting content will be produced by the manager's core client accounting software. The importance of maintaining the integrity of the accounting records, means that the ability to input data to this software and manipulate the way in which it is presented must be limited to a comparatively small number of people in the accounting and IT functions. The volume and complexity of the data stored in and processed by this software means that upgrades to the software are a major project which usually means that they occur relatively infrequently. For the same reason, it is a major undertaking for an investment manager to contemplate a switch to a different accounting system.

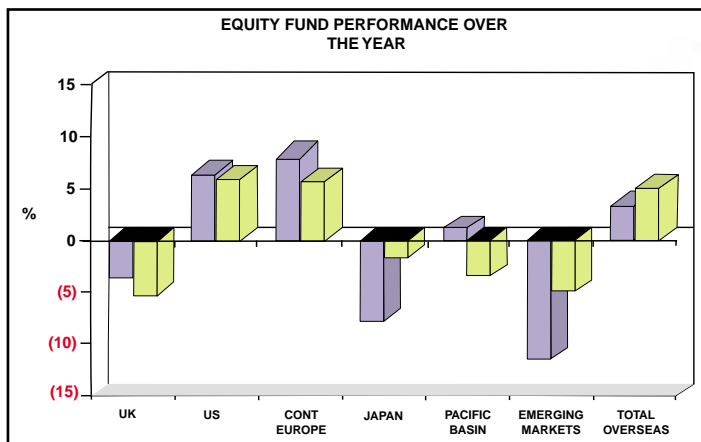
Therefore the document of record component of an investment manager's quarterly reports tends to be produced on "legacy" IT systems which lag the latest technology. These systems are tried and tested and therefore they are dependable which is the most important requirement they have to meet. However, the statements which they produce tend to be rather poorly presented, often with rather cryptic and limited explanatory information and with little flexibility. None of this is to say that investment managers do not work hard to upgrade their client accounting systems. However, this is a continuous process in which investment managers systems are doomed to lag what the managers would really like to be able to show their clients.

These systems problems do not arise in quite the same way in relation to that part of the report which is concerned with ex-

plaining policy and accounting for performance. The freedom which the investment manager has to choose the content of this element of the reporting and the fact that this report can rely on the core information from the documents of record, means that the investment manager has greater freedom to use more flexible and up-to-date software in this element of the report and ought also to be able to be more responsive to particular requests from clients. What should the client therefore expect to be able to see?

The first thing which the client wants to see is a statement of performance. How much were the investments worth at the beginning of the period, how much were they worth at the end of the period and what return does this represent once one has taken into account any new money or withdrawals during the period and the income received? This information then becomes the starting point for establishing whether or not the performance has been satisfactory.





possible to see which parts of the portfolio are performing well and which parts may be lagging. The following charts show how we present this information in our reports.

We think there are four tests to be applied to this performance number.

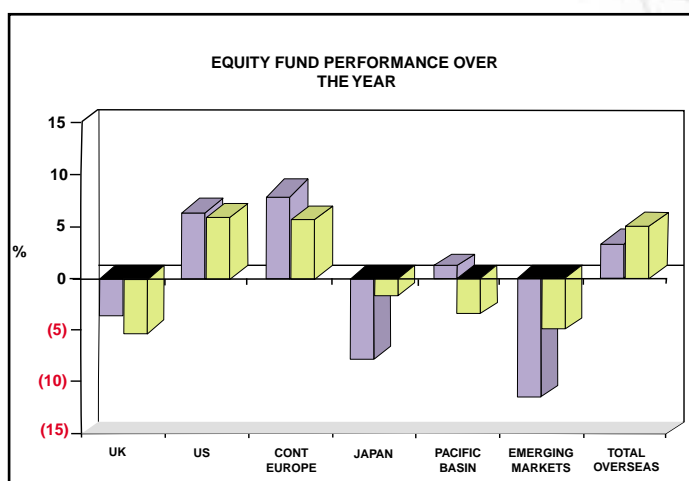
The first test is a comparison of the return over the period with the risk-free return which could have been earned by simply leaving all the money on deposit and with the rate of inflation. We call these the "acid tests" because there is no point in having stock market investments unless they do significantly better than cash on deposit and provide a real return over and above the rate of inflation. The following charts illustrate how we present this information in our own reports on both a short and long term basis.

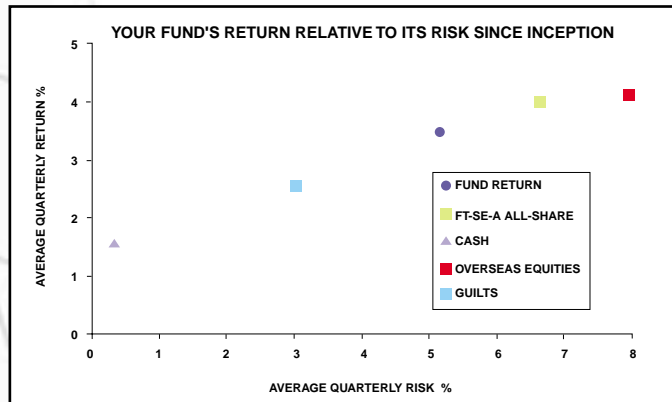
Having said that they are the starting point, we recognise that these acid tests are easy tests to beat most of the time and therefore the second level of testing must address the question of whether or not the investment manager is making the most of the stock market environment. This consists of comparing the performance of each part of the portfolio against the relevant stock market index - in other words, the return from the UK equity element of the portfolio against the UK equity index, the return from the US equity element against the US index and so on. By breaking down performance in this way is it

The client's fund return is the blue column in each of these charts.

The third test to be applied where possible is some sort of peer group comparison which addresses the question "has my investment manager done as well as other managers?". The private investment world has lagged the institutional investment world considerably in the evolution of peer group surveys and it remains very difficult to obtain meaningful comparisons with the results achieved by other investment managers. However, in the UK, for example, we now have a basic form of peer group comparison possible through the creation of the WM Private Investor Indicators and the FTSE/APCIMS Private Investor Indices.

Both these sets of indicators are created by polling a large number of investment managers in order to discover the asset mix which they are following for their clients, broken down into growth-orientated funds, income-orientated funds and balanced funds. Once this asset mix infor-





more, it is not a definition of risk which can be applied to other forms of investment in quite the same way. For example, there is little risk of the Government failing to honour its obligations in the

mation has been aggregated it becomes possible to identify the average asset mix being employed by these investment managers for their private clients. By applying the relevant stock market indices to each of these asset categories, it becomes possible to quantify the overall performance which this average asset mix is producing.

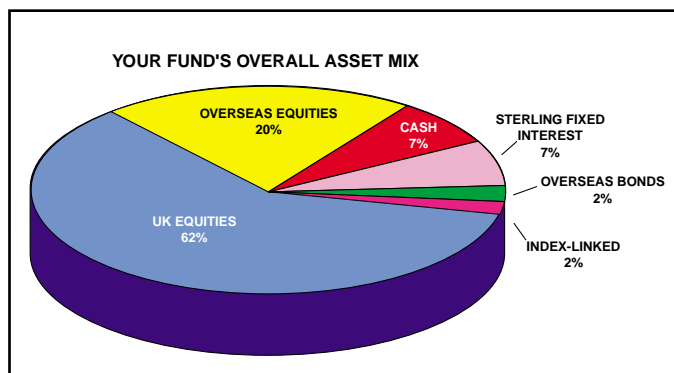
This sort of notional exercise falls a long way short of providing the sort of peer group comparison which is possible in the institutional world where investors are able to compare their returns with the actual returns of their peers. Furthermore, comparison is complicated by tax and other factors. However, it is still better to have the information and then take account of qualifying factors than not to have the information at all. Therefore, where comparisons of this sort are available, it is important that they be included in the investment manager's report.

The fourth performance test which we think it is important to apply, is a test of the risk which has been taken in order to produce the return.

In one sense investment risk means the danger of a company in an investor's portfolio failing and its shares becoming worthless. However, this is a narrow definition of risk since it deals only with the extreme form of risk and if the investor wishes, risk of this nature can be reduced by diversification to the point where it does not really matter anyway. Further-

the gilt-edged market, but gilts can be highly volatile in price so they certainly involve some form of risk.

Against this background, it is common practice to define risk as the volatility of return from an investment as measured by the standard deviation of its return over time. The wider and more variable the range of returns which an investment generates over time, the greater its inherent risk as evidenced by the higher standard deviation of its return. Similarly, the lower the standard deviation, the lower the inherent risk. Common sense suggests that shares are more volatile and therefore riskier than bonds whilst both are riskier than cash on deposit. Using standard deviation it becomes possible to quantify these differences in risk and relate them to the returns which these and other forms of investment offer.



Once the risk and return characteristics of the investment environment have been quantified, it becomes possible to see a portfolio's return in proper perspective. For example, if two portfolios have each given a return of 20% per annum then, on the face of it, both returns are equally satisfactory. However, if one of the portfolios

had at first doubled in value and then fallen back sharply to give the overall 20% return, whereas the other had compounded gradually at a consistent 4% to 5% a quarter to reach the 20% return, the latter would represent the better quality return since it would have been achieved with less risk.

Against this background, we think it is important for investment managers to say something quantitative about the degree of risk which has been taken in order to produce the client's return and the following chart illustrates the methodology which we employ.

The second question which the client wants the report to address is "what is the outlook for world stockmarkets?". This calls for the usual sort of commentary in which the investment manager describes the stock market environment in recent times and identifies the main influences which are likely to bear on markets in the period ahead. Most investment managers are very happy to pontificate at length along these lines but the really important question for the client is how this assessment of the outlook is being translated into investment policy in their particular portfolio.

This calls for the report to include some sort of statement of the portfolio's overall asset mix and some sort of comparison of this asset mix with a benchmark or, where available, some sort of peer group asset mix.

This purpose of this comparative data is to allow the client to see the asset categories in which the investment manager is "overweight" and those in which the manager is "underweight". The client will want to see that these over and underweightings tie in with the manager's general assessment of the investment outlook.

It will also be important to see the degree of overweighting or underweighting which the manager has put in place since this conveys important statements about the degree of risk being taken. In other words, although two investment managers may both say that they are very cautious about the outlook for US equities, one investment manager may translate this into holding no US equities at all whereas another investment manager may translate this into holding only, say, 5% in US eq-

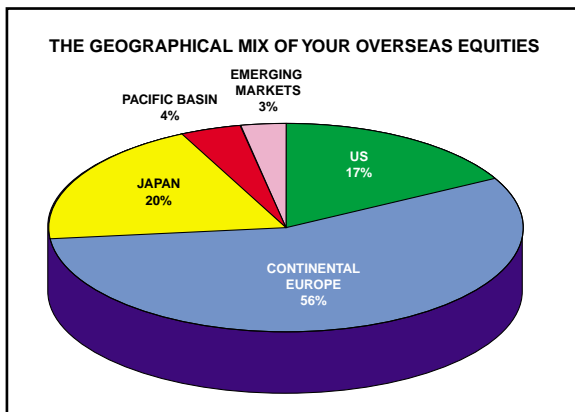
uities where they would regard a normal weighting as 10%.

For this reason, the investment report should not only tell the client what views the investment manager holds about the outlook but how strongly these views are held as evidenced by the extent to which the investment manager has moved away from the normal long term balance of the

the period ahead by comparing the current asset mix of the portfolio and our three month target with the long term planning ranges for each asset category and the asset mix of the relevant peer group benchmark.

It can be seen that we have found it helpful to place a heavy emphasis on charts and tables in our reporting. Our clients are busy people so, although they

want our reports to be exhaustive, they want them to be a quick and easy read with the main messages leaping off the page. Indeed, although our standard report runs to over 20 pages, some clients have asked for hardly any text at all and just like to have the key charts. In these cases we have been able to achieve the "Holy Grail" of the comprehensive investment report quite literally



portfolio in giving effect of these judgements. Where peer group comparisons are not available to provide a context for these asset allocations, it can be helpful for the manager to substitute planning ranges which allow the client to see the current portfolio asset mix in the context of the ranges within which the asset mix may vary over the years.

The following extract from our quarterly reports illustrate the way in which we have found it helpful to present this information for our clients.

The two pie charts show the overall asset mix of the client's portfolio and the split of the overseas equity element of the fund. The column chart helps the client see where we have placed the emphasis within the overseas equity investments compared to the "neutral" position as represented by the weightings of the world index. A table shows our planned policy for

on one piece of paper!

Summing up, clients of investment managers will always tend to get fairly "clunky" account statements and portfolio valuations since these are often produced by systems which are doomed to lag the latest technology as the price to be paid for their dependability. However, clients are entitled to expect a high standard of reporting when it comes to the explanation of policy and performance which can be produced using much more versatile and attractively presented systems.

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