The art and science of portfolio construction

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Today, investors are faced with a wide range of investment risks including COVID-19, the war in Ukraine, China's regulatory clampdowns, global recession, high inflation, enormous sovereign debts, social unrest, rising interest rates, and supply chain disruptions.

Amidst such uncertainty, the importance of creating robust and focused investment portfolios that consistently deliver to their stated objectives cannot be overemphasised. Simply put, portfolio construction is the design and implementation part of an investment process; the objective is to harness the various drivers of returns optimally throughout the investment cycle, in a cost-effective way.

Portfolio settings matters

The primary challenge in comparing portfolio construction capabilities of different managers lies in how managers define their portfolio settings. Portfolio settings include return objectives, investment terms, risk capacity and constraints. For example, there are several portfolios in the Association for Savings and Investment South Africa (ASISA) medium equity sector, which have a return objective of CPI +4% p.a. However, the differences are seen in how their risk capacities are defined, either in absolute or relative terms, and the recommended investment term.

All these factors influence the return outcomes. Financial advisers should assess that the portfolio settings are realistic and present a reasonable likelihood that the return objectives will be met through the cycle.

Quality and quantity of exposures

Asset classes, sectors and securities form part of the holdings-based exposures. Investors often use the quantity of asset classes as a measure of overall diversification. This makes sense when the intention is to have a general gauge of the number of return drivers. However, the approach is inadequate for assessing the quality of diversification. For example, consider a multi-asset medium equity portfolio that outperforms its peer median benchmark over a meaningful period. If attribution analysis shows that only three out of eight asset class strategies outperformed their respective peer benchmarks, one could argue that the five underperforming asset class strategies were sub-optimally constructed.

A sophisticated approach to comparing multi-asset portfolios is by assessing the style factor exposures. Style factors are statistically significant economic variables that drive returns of securities. For income securities, these include nominal and real duration, credit quality and liquidity. Similarly, style factors for equity securities include quality, financial health, size, volatility and momentum. The drawback is that style factor analyses require good performance attribution systems which may not be accessible to most investors.

Management skills and indexed exposures

Empirical evidence from the analysis of 25 years of fund returns confirms that there are varying degrees of alpha opportunities across asset classes. Understanding the effectiveness and suitability of active management in different asset classes can highlight some key differences. Active management has the potential to significantly enhance risk-adjusted returns in interest-bearing asset classes, given that the often-used benchmark for long-bond managers, the FTSE/JSE SA All Bond Index, only holds the largest 20 vanilla bonds by market capitalisation, excluding thousands of attractive securities.

In contrast, a manager may prefer to hold indexed exposure to global equities, given the evidence that most global developed equity managers have underperformed the MSCI World Index over the past two decades, at a lower cost.

Assessing portfolio construction capabilities is a delicate balance of art and science. The key lessons for financial advisers are:

- There's no one-size-fits-all in assessing portfolio construction capabilities. However, the common goal is to maximise the risk-adjusted returns;
- Measuring the quality of diversification within asset classes helps to identify where the active management skill has been superior to peers; and
- Indexed exposures can be actively used to manage style factor exposures and reduce costs.

Robust and focused portfolio construction may not avert the impact of every risk we face today. However, it goes a long way in determining how far or close a portfolio path is relative to an investor's return objectives and risk tolerance. ●