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From the Editor

On July 2nd, 2008 the market officially slipped into bear territory when the Dow Jones Industrials and other market indices reached the point 20 percent below the October 9th, 2007 high of 14,164.53. In this tough economy where market downturn is widespread across sectors, it is difficult to find an investment strategy that will beat the benchmarks. Where can an Investment Manager turn to improve performance? Chito Jovellanos, *forward look inc*., makes a strong case at looking inward at investment operations to pack on a few basis points!

I hope you enjoy this issue of VENTURE *NAVIGATOR*. As always, feedback and suggestions for future issues can be emailed to jcavallaro@venturefsg.com.

Sourcing Alpha Within Investment Operations

A Research Note

Chito Jovellanos, President, forward look, inc.

As most everyone knows, alpha stems from a manager's skill, which is expressed through a target portfolio representing their view of assets that will outperform a benchmark. This ideal portfolio however needs to be translated into reality, and reality is fraught with implementation issues – e.g., can't short that stock? has the execution price moved away from the model's parameters? couldn't the trader exit the position in time? did they 'fat-finger' the option symbol?

Intuitively, the quality of the investment operation (spanning services from trading to settlements) at the manager's firm either enables the desired outcome or significantly dilutes the potential of their strategy. So exactly how much can operational efficiency contribute to realized investment performance?

In seeking to answer this question, *forward look, inc*. revisited data from its client engagements spanning Q4 1999 to Q2 2006. As with most client projects, the mandates were expressed in tactical terms (e.g., "we want to streamline our emerging markets operation") but surprisingly yielded, in hindsight, strategic benefit in terms of improvement to the underlying portfolio's performance.

In brief, the firms in our study ranged from $5-100+B AUM, with individual funds typically running between $250M - $1.1B of managed money. Asset classes included equities [~65%], fixed income [~15%], and listed derivatives. Geographies covered were global (developed [~80%], emerging), and all sectors were represented, including alternatives. Strategies included long-only, long|short, and equitization.

Methodology

We selected those projects where only one very specific process was modified (e.g., voluntary corporate actions management) or only one highly focused technology was implemented or retooled (e.g., optimizing cancels for algorithmic trading). Just as importantly, all other elements surrounding these funds' operations had to have remained constant. This approach provided a form of *a posteriori* control where we were examining only the effects from one imputed variable. The data screen

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resulted in 52 fund samples (from a population of 138 investment portfolios across 19 asset managers) where all known factors (e.g., style, exposure, concentration, manager[s], etc.) were constant throughout the observation period, except the one operational change that was introduced by the project. Performance attribution data was provided by our clients (calculated using a mix of holdings and transactions-based techniques at weekly or monthly intervals).

Our minimum sampling period was three contiguous calendar months, with the bulk of our data collection spanning a six to nine month window.

Results

The key observation was a 50-250 basis point improvement in risk-adjusted performance (annualized, gross of fees) for the underlying portfolios that were affected by our clients' initiatives. As noted in the preceding section, we filtered on data that showed performance attribution to be constant, but with returns and measures improving. Effects were visible generally within 6-9 months of project initiation. Highlights of our results follow.

Figure 1 provides an overview of all the 52 sampled funds and the measurable improvements in their performance. The 'average' is represented by a cluster center indicating a 119 basis point improvement within 7 months of the project's initiation. Note that these funds were tracked across extremes of market cycles - both bear (2000-2002) and bull (1999-2000; 2003-2006), and performance improvements were measured relative to the benchmark - not absolute return.

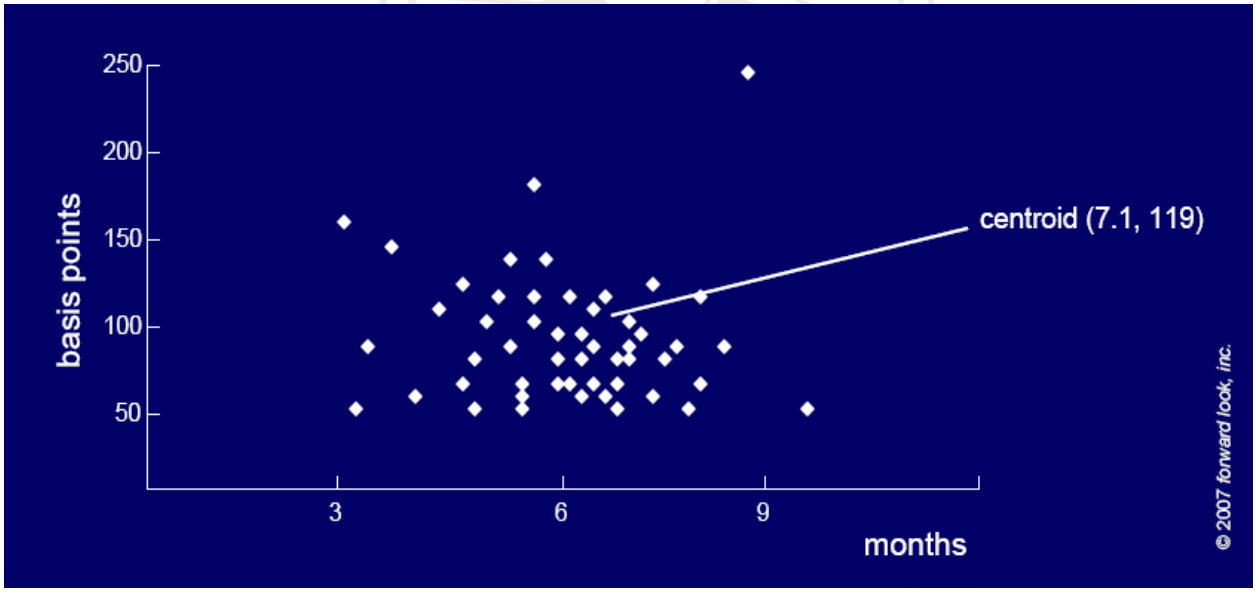

FIGURE 1

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Figure 2 categorizes the various projects into functional initiatives and, for each category, describes the project where the maximal performance gain was observed.

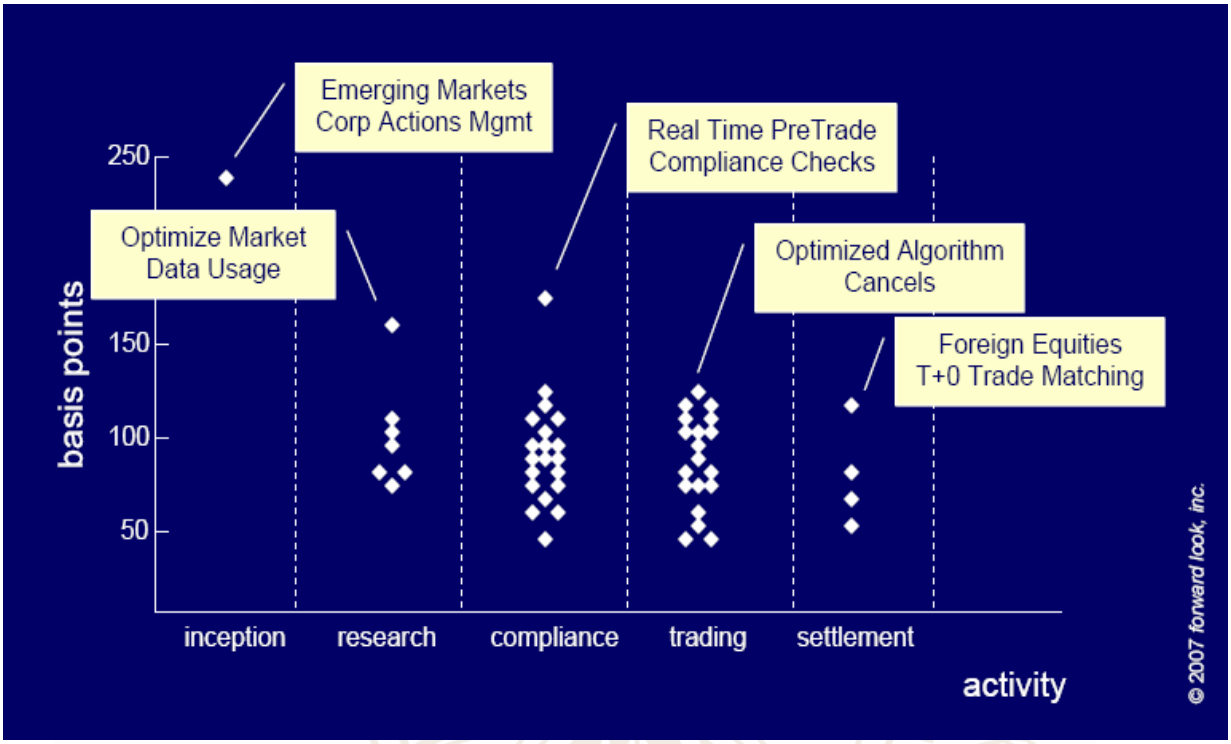

FIGURE 2

We also sampled other funds (8 in total) outside of the set of 52 that made up the immediate study. In these cases, two operational updates were being applied concurrently (e.g., "implement broker matching via Omgeo" plus "automate settlement date reconciliation with prime brokers"). Our provisional analysis strongly suggests that single optimizations dominate, i.e. the familiar '80/20' rule. Optimizations are not additive, most likely due to correlated effects.

Discussion

What was the cause of these observed improvements in performance? Our intuition suggested that weak information flows within a firm are the precursors to implementation shortfalls.

More formal factor analysis we conducted also indicated that these shortfalls in the portfolio implementation framework stem from 'Information Latency' i.e., the inability of people and systems to deliver and act on data in a timely manner. For example, the effectiveness of the shorting strategy is dependent on the lending data consolidated into the manager's models or trade lists; execution quality is compromised if the traders cannot adjust their approach when the fills from EMS's roll up erratically into their OMS blotters; income is incorrectly reported because of misclassified entries when booking foreign tax reclaims from custodian's notices.

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Interestingly, many of the performance attributions we examined did not sum to unity. We believe that these unexplained residuals are attributable to Information Latency, rather than 'idiosyncratic factors,' as typically noted today. See Figure 3, below, for a conceptual framework of Information Latency. For an overview of the underlying data used in our factor analysis, please refer to the Appendix at the end of this article.

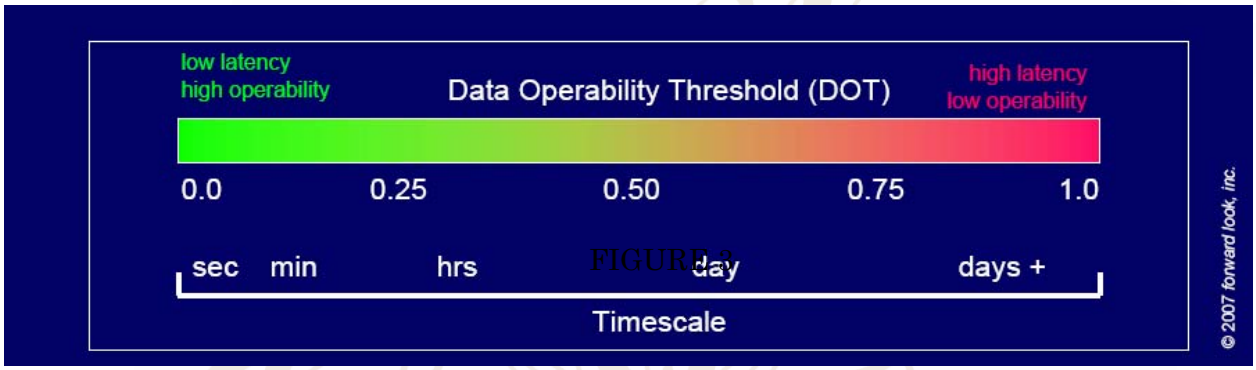

FIGURE 3

When we presented these results at the Plan Sponsor and Consultant Circle Summit (San Francisco, Oct. 2007), the insights clearly resonated with a number of constituencies:

For the institutional investor, they could see using these techniques as a predictive tool to
- improve fiduciary oversight (i.e., establish the quality of the manager's operations)
- identify, engage and retain the better managers (i.e., based on skill plus operational competencies); and
- maintain on-going due diligence (i.e., a methodical process for evaluating their manager's operational soundness).

For the investment manager, they saw it as a prescriptive tool to
- improve strategy and product performance; and
- better capture and retain clients.

At this juncture in the markets, many asset managers are likely looking for alpha in all the wrong places. Industry-wide, firms are exhausting similar strategies (e.g., 'short extension') and more than likely diluting each other's returns. As this latest bull run fades away, trending markets bolstering performance are no longer a serendipitous ally. Conversely, taking on more risk in the hope of achieving better returns heightens the probability of sub-par performance given today's credit-induced volatility. And for dollar-based investors in this inflationary climate, holding on to cash is akin to slowly drifting backwards.

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So what other options does a manager have to beat their benchmarks? Perhaps looking inward at the quality of their investment operations is a long-overdue alternative. It could potentially yield anywhere from 50-250 basis points in risk-adjusted performance. Moreover, looking deeper into the sources of Information Latency at a firm can help clarify the ROI for remediation choices, and select the most substantive initiative that will address implementation shortfalls.

References

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http://www.riskforecast.com

Appendix

As part of our pro-forma approach to projects and the associated workflow analysis, we profile and monitor key categories of (time stamped) data, comprised mainly but not exclusively of:

- inputs to model(s) e.g., company fundamentals and market data sourced from vendors and exchanges
- outputs from the manager's models and-or optimizers e.g., trade lists
- compliance records, client guidelines and other constraints that were applied to the portfolios
- orders
- fills and trades
- settlement records, e.g., custodian SWIFT messages.

Our in-house tools allow us to interrogate and analyze data in various formats, and establish where the lags and inefficiencies in information flows exist. We then focus our remediation efforts on those areas that are flagged as operational 'soft spots.'