

# SENIOR CONSULTANT

The Voice of the Investment Management Consultant

## Investment Consulting Craft Trades Up to 21st Century: Update

Ron Surz, President, PPCA, Inc.

This is the season that we turn our attention to our business plans for the new year. Virtually everything I have read recently about this important endeavor is focused on asset gathering, to the exclusion of the quality of service being provided. How can we expect to keep the assets we gather if the service is lousy? I guess this works if the competitors' service is just as bad, or the clients are asleep at the wheel. Last year I wrote an article on this subject that received rave reviews, but the article seems to have had little impact. The article appears again in the following, with only minor updates. I hope it is helpful to your 2004 business planning.

Successful investment consulting encompasses two distinct crafts: the ability to develop quality advice and the skill to deliver that advice. This article focuses on the pressing need for the use of current technology to bring about evolution and modernization in the first of these crafts. Only if this occurs can clients truly benefit from what we have learned about investing over the past 20 years.

Before we go any further, we should point out that the second craft – that of delivering advice and guidance – has been evolving quite nicely and, in fact, has never been in better shape than it is today. The deliverer of advice has progressed from report schlepper/salesman to trusted advisor. In many ways, the consulting industry has compensated for its lack of advancement in the quality of advice by significantly enhancing the delivery of that advice. Now it's time for clients to get the quality goods.

So, here's the basic question: As it is practiced today, is the development of investment advice a craft or a trade? The dictionary distinction between craft and trade is that craft requires skill, while trade does not. Following the path of natural progression, the development of advice has evolved into more of a commodity and, therefore, more of a trade than a craft. Does that matter? It certainly matters to the consultant's clients

who rely upon, and pay for, the craft. Accordingly, the key to consulting's smooth transition to a trade is delivering the craft. Sound like a riddle? Read on.

Both craftsman and tradesman are noble occupations. To clarify the distinction between the two, the story of the chair may help. In the early days of the chair, craftsmen fashioned all styles of seating, from sturdy barstools to elegant thrones. Then the Industrial Revolution carved the way for the chair trade. Chairs are now mass-produced in many varieties for broad distribution. The craft remains with the designers and upholsterers, but the manufacturing of chairs has become a trade. Some craftsmen still make chairs by hand, demonstrating that craft can co-exist alongside trade.

Investment consultants are undergoing a similar transition as they move toward becoming distributors of mass-produced solutions and away from devising custom advice and guidance tailored to a client's specific circumstances and needs. Custom advice and guidance require skill, while mass distribution does not, although its success depends on the craft in much the same way as the chair manufacturer relies on the designer. Both the craft and the trade of consulting are worthy and

honorable endeavors as long as the client realizes the difference. A good consulting tradesman will find and use the best consulting craftsman to assure that the client masses are getting a high-quality product.

The distinction between craft and trade is particularly apropos as we mark the 51st anniversary of Modern Portfolio Theory (MPT). The seminal work of Dr. Harry Markowitz on efficient portfolio construction was first published in 1952. This work, coupled with that of Graham and Dodd, separated the world of economics from that of finance and formed the foundation for the craft of investment consulting. Let's examine how the craft has evolved over the past half century, with an eye toward the benefits to the client. MPT explains quite clearly that investors should require

**SUCCESSFUL  
INVESTMENT  
CONSULTING  
ENCOMPASSES TWO  
DISTINCT CRAFTS:  
THE ABILITY TO  
DEVELOP QUALITY  
ADVICE AND THE SKILL  
TO DELIVER THAT  
ADVICE**





greater expected returns for exposing themselves to greater risk and that, over time, these risks should be rewarded. Patience is **not** its own reward; higher returns are. MPT further advises against putting all of your eggs in one basket because a well-diversified portfolio offers less risk for a given level of expected return. Good solid basic stuff. Over the past 50 years, we've learned many important lessons, most of which derive from these basic tenets.

One of these lessons is that investment policy, or asset allocation, is by far the most important determinant of investment results. In other words, determining the amount allocated among stocks, bonds, real estate, etc. is undoubtedly the most important decision an investor makes, and it's an unavoidable decision. MPT gives us a framework for making this decision in the form of an efficient frontier, the envelope of portfolios with the best returns for a given level of risk. All the clients need to know is the level of risk they want, and *voilà*, out pops the answer. However, the clients rarely know what risks they want. In fact, they look to the consultant to manage risk, whatever that means. Furthermore, risk is not the same as volatility, as commonly used to construct the efficient frontier. Risk is failure – failure to keep what you've got, or failure to meet a future obligation. Volatility overstates risk by including success. In addition, capital markets are not all that efficient, due in part to investor behavior, which was supposed to keep the markets efficient but instead, messes them up.

Another lesson we've learned is that active managers rarely earn their fees, especially after taxes, and that the majority of investors chase the infamous "hot dot," resulting in even worse performance. Studies have shown that the average investor in a typical mutual fund earns less than that mutual fund earns over time, because the investor switches in and out at precisely the wrong times. Further exacerbating this problem, the average mutual fund typically underperforms an appropriate passively managed – and cheaper – alternative.

There are other lessons, but let's stop with these two and consider the ways they have

changed investment consulting. Has the craft evolved to encompass these lessons?

Most of the evolution of the consulting industry, especially with the advent of the Technology Revolution, has been in efficiency, not in adding value for the client, except perhaps through lower fees. The Revolution has had a profound effect on the evolution of the trade, but not of the craft. Virtually all of the focus and use of technology has been toward improving back office operations and client relations. The client sees the fancy report and the birthday card, and is pleased. In the meantime, research is manufactured at the home

proposition. However, this technology is grossly underutilized because it is not the type of technology that streamlines operations. In investment policy consulting, the client's risk tolerance can be elicited through a thoughtful and sensitive series of conversations focusing on probable future scenarios given different levels of risk. Part of this craft is art, and part is science. The art part is the conversations, the sensitivity to client reactions and the transformation of those reactions into guidelines. The science part measures risk as losing wealth, covers multiple time periods and deals head-on with the nuances of taxes, cash flows and inflation. It's not easy to collect the inputs for this technology, which include capital market forecasts and client assumptions, and it takes time and energy to interpret the results. But, this is the most important decision the client makes.

Similarly, consultants can help clients improve the odds of actually finding investment manager talent. Do consultants believe managers have skill? Do consultants know who these skillful managers are? Are consultants personally invested with these managers? We've recently discovered that investment style is an important determinant of performance, ranking second only to investment policy, and that skill within a style tends to persist. Good

growth equity managers continue to be good growth equity managers. Ditto for value. Unfortunately, we routinely confuse style with skill. Witness the mass firings of value managers just two short years ago.

We've also learned that value and growth go in and out of favor, so you can try to call the style turns, or avoid making the wrong call by maintaining style neutrality. Whichever choice you make, you'll want to employ managers with skill or, if you can't find skill, invest passively. The search for skill is enhanced by new technologies that first determine success or failure by separating out style effects, called performance evaluation, and then identifying the sources of the value added above style, otherwise known as performance attribution. Superior scientific universes are now available that provide unbiased indications of manager

**THE SEARCH FOR SKILL IS ENHANCED BY NEW TECHNOLOGIES THAT FIRST DETERMINE SUCCESS OR FAILURE BY SEPARATING OUT STYLE EFFECTS, CALLED PERFORMANCE EVALUATION, AND THEN IDENTIFYING THE SOURCES OF THE VALUE ADDED ABOVE STYLE, OTHERWISE KNOWN AS PERFORMANCE ATTRIBUTION**

office or farmed out to service bureaus, which have not evolved the craft. The frontline consultant appears with a kit of the same old pre-packaged solutions. The craft of consulting is evolving into a trade. Good for business, but is it good for the client?

The introduction of MPT in the 1950s led to significant improvements in advice and guidance for about 30 years and made the investment consulting profession possible. Today, much of what consultants deliver is virtually the same as it was 20 years ago. Advice and guidance on the frontlines have not evolved much, because mass production has focused on efficiency, not innovation. As a result, the client often does not receive the benefits of new knowledge.

Technology is available today to help consultants deliver on their value-added

success or failure, so performance evaluations are fair, accurate and timely. Similarly, contemporary attribution analyses properly identify the reasons for this success or failure. In contrast to the attribution analyses developed 20 years ago and still widely used today, which promote the mistake of confusing style with skill, the new contemporary technology actually helps identify investment manager talent.

We can expect the trade of investment consulting to persevere, but the craft of developing investment advice will move down three separate and distinct paths. One path will support the continuing evolution toward a consulting trade by providing the best advice and guidance to the masses as a commodity. A second path will maintain the cottage-industry focus on individual and tailored solutions for unique client needs. Both of these paths for the craft will ultimately discover the value of computer technology for enhanced decision-making, and the sooner the better. The trade has already recognized this value. It's only a matter of time before the craft catches up. The third path for the craft will be extinction. Like those artsy crafted chairs of the 1950s that you couldn't actually use, some will continue to cling to the craft of the 1980s and become obsolete. ■

**Endnote**

Many thanks to those who commented on this article; their suggestions and encouragement are greatly appreciated. Thanks to Mike McGrath of IMCA, Steve Winks of Senior Consultant, Bill McVay of Zephyr Style Advisor, Dave Loeper of Finaware.com and Bob Clelland of RB Clelland & Associates. Also, special thanks to Gale Morgan Adams for her remarkable editing.

**About the Author**

Ronald J. Surz is president of PPCA, Inc., a California-based computer software firm specializing in innovative analytic tools for sophisticated investors and their consultants. PPCA is the developer of StokTrib, a holdings-based style analysis and performance attribution system, applicable to both U.S. and non-U.S. portfolios. PPCA is also the creator of Portfolio Opportunity Distributions (PODs), which offers superior scientific benchmarks for evaluating investment performance. Use of these PODs to measure performance against the popular indexes (PIPODs) is a recommended [Senior Consultant Toolbox Solution](http://www.SrConsultant.com/Toolbox/toolbox.html) (<http://www.SrConsultant.com/Toolbox/toolbox.html>).

Ron is a member of the Investment Performance Council of the Association for Investment Management and Research (AIMR) and is also on the board of the Investment Management Consultants Association (IMCA). He has earned an MS in Applied Mathematics and an MBA in Finance, and holds the Certified Investment Management Analyst (CIMA) designation. Ron can be reached at 949-488-8339 or [Ron@PPCA-Inc.com](mailto:Ron@PPCA-Inc.com)



For more information about superior scientific universes (PIPODs) that provide unbiased indications of manager success or failure, and how to generate performance evaluations that are fair, accurate and timely, visit our [Consultant's Toolbox](http://www.SrConsultant.com/Toolbox/toolbox.html) (<http://www.SrConsultant.com/Toolbox/toolbox.html>).

**Notes**

**SENIOR CONSULTANT**

**THE VOICE OF THE INVESTMENT MANAGEMENT CONSULTANT**

JAMES P. OWEN  
Co-Founder

STEPHEN C. WINKS  
Co-Founder, Publisher & Editor-in-Chief

SYDNEY LEBLANC  
Consulting Editor

MAMIE WOO MCNEAL  
Production Editor

EDDIE BRYANT  
Marketing Consultant



**Advisory Board**

JERRY BOTT  
Bott Anderson

JOHN BROCK  
Brock-Hazzard/Wachovia Securities

DICK CHARLTON  
New England Pension Consultants

BOB CLUCK  
Canterbury Capital

HAROLD EVENSKY  
Evensky Brown & Katz

JEFF FRUM  
Wells Fargo

RICH GLEASON  
Salomon Smith Barney

KATHLEEN E. HEGENBART  
Salomon Smith Barney

BRIAN HUNTER  
Prudential Securities

GREG HUNTER  
Merrill Lynch

BILL JOHNSON  
CapTrust

JOHN KELSEY  
Salomon Smith Barney

KEITH PHILLIPS  
Morgan Stanley Dean Witter

BOB ROWE  
Morgan Stanley Dean Witter

DICK SMITH  
Capital Advisory Group

JIM YANNI  
Yanni Partners

**SENIOR CONSULTANT**

1457 Crystal Springs Lane  
Richmond, Virginia 23231  
Ph 804-643-1075 ■ Fax 804-643-1544  
[WWW.SRCONSULTANT.COM](http://www.SRCONSULTANT.COM)