

Linking your Decisions to your Results

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Case Study:

Large Cap US Equity Portfolio

- Index: Top 150 US stocks, cap-weighted
- Portfolio: 75 stocks selected from index
- Constraints: None
- Goal: Maximum excess return at 99% confidence level
- Portfolio Construction:
 - a) Manager sets long-term sector weightings
 - b) Manager selects stocks
 - c) Manager makes tactical sector bets

Identifying the Investment Decisions

1. Choice of Performance Benchmark

- *Broad Market*
- *Style and Factor Exposures*
- *Efficiency*

2. Unique Strategic Allocation

- *Applies Capital Markets Insights*
- *Exploits Benchmark Inefficiencies*

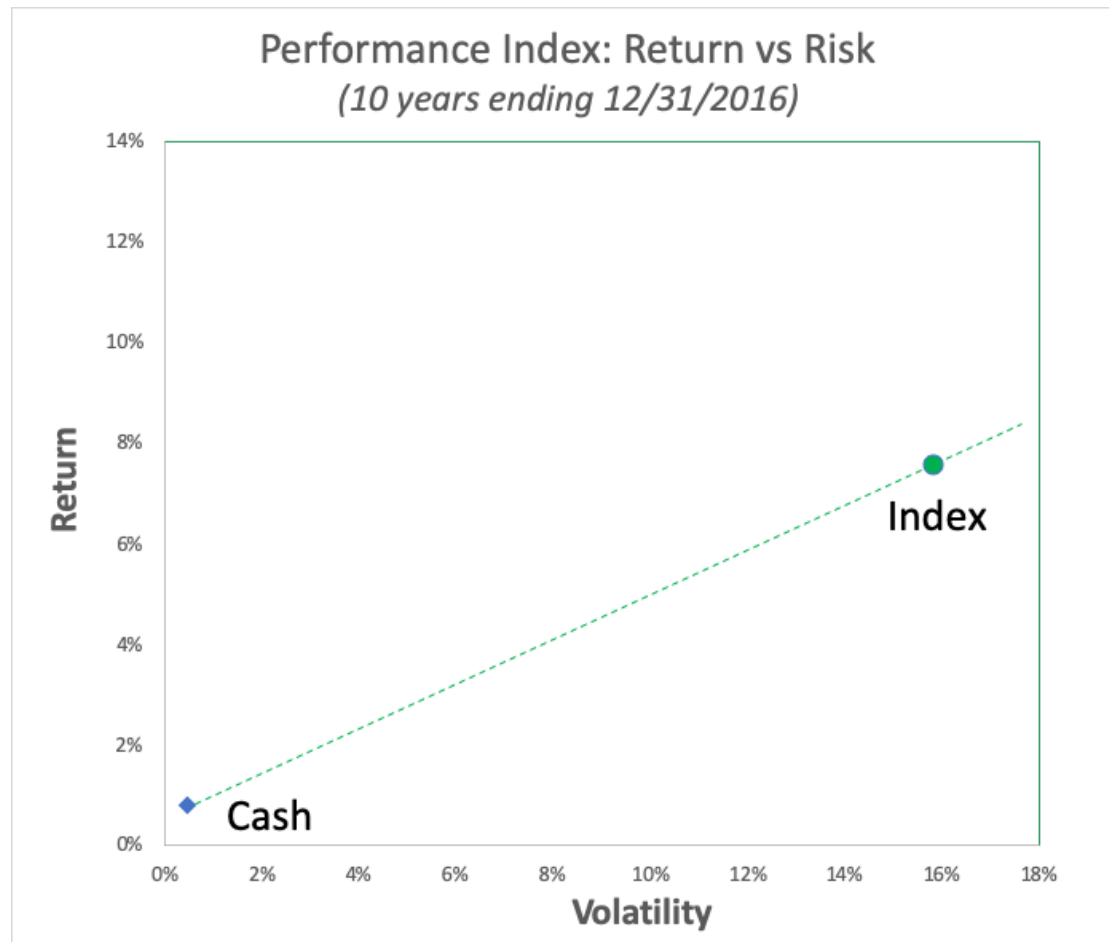
3. Investment Selection

- *Rules-based*
- *Consistent with tactical allocation decisions*

4. Tactical Allocation

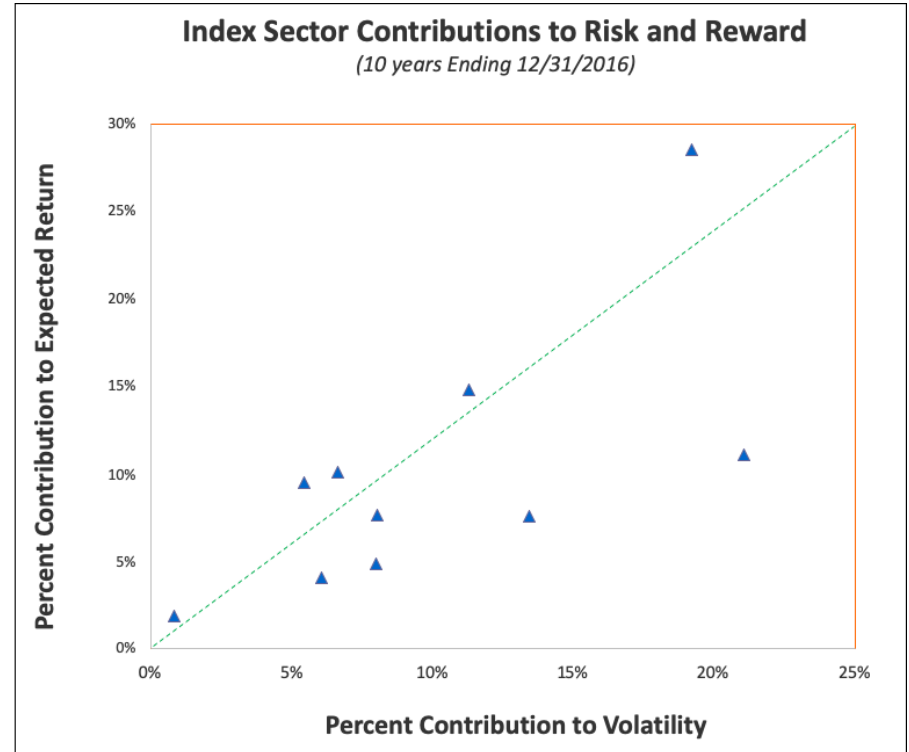
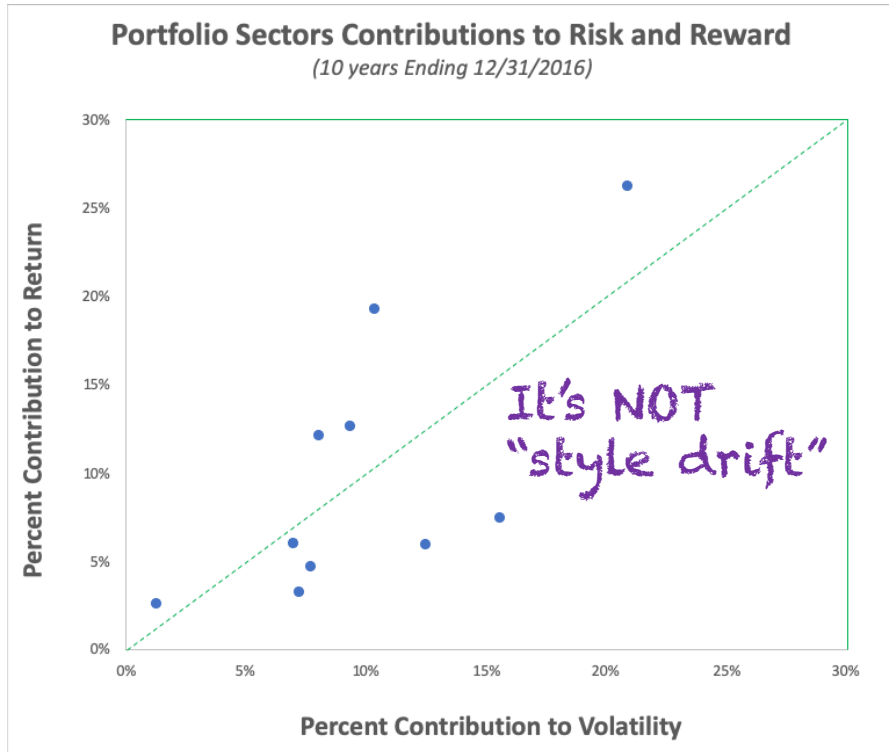
- *Opportunistic / Defensive shifts*
- *Maximize Return / Minimize poorly-compensated Risks*

Investment Decision #1: Performance Benchmark



Benefit of Investment Risk:
675 bps over Cash

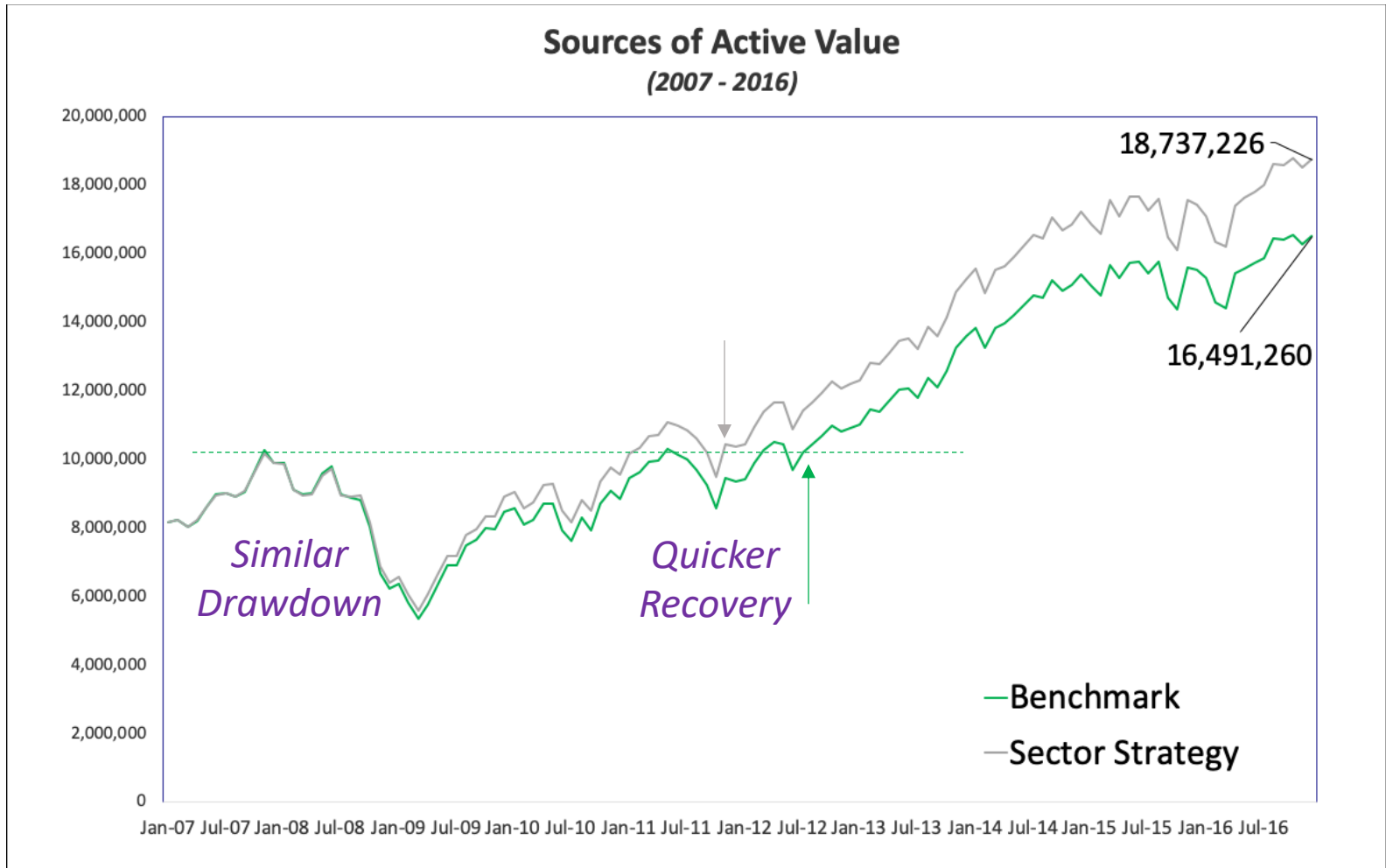
Decision #2: Strategic Sector Allocation



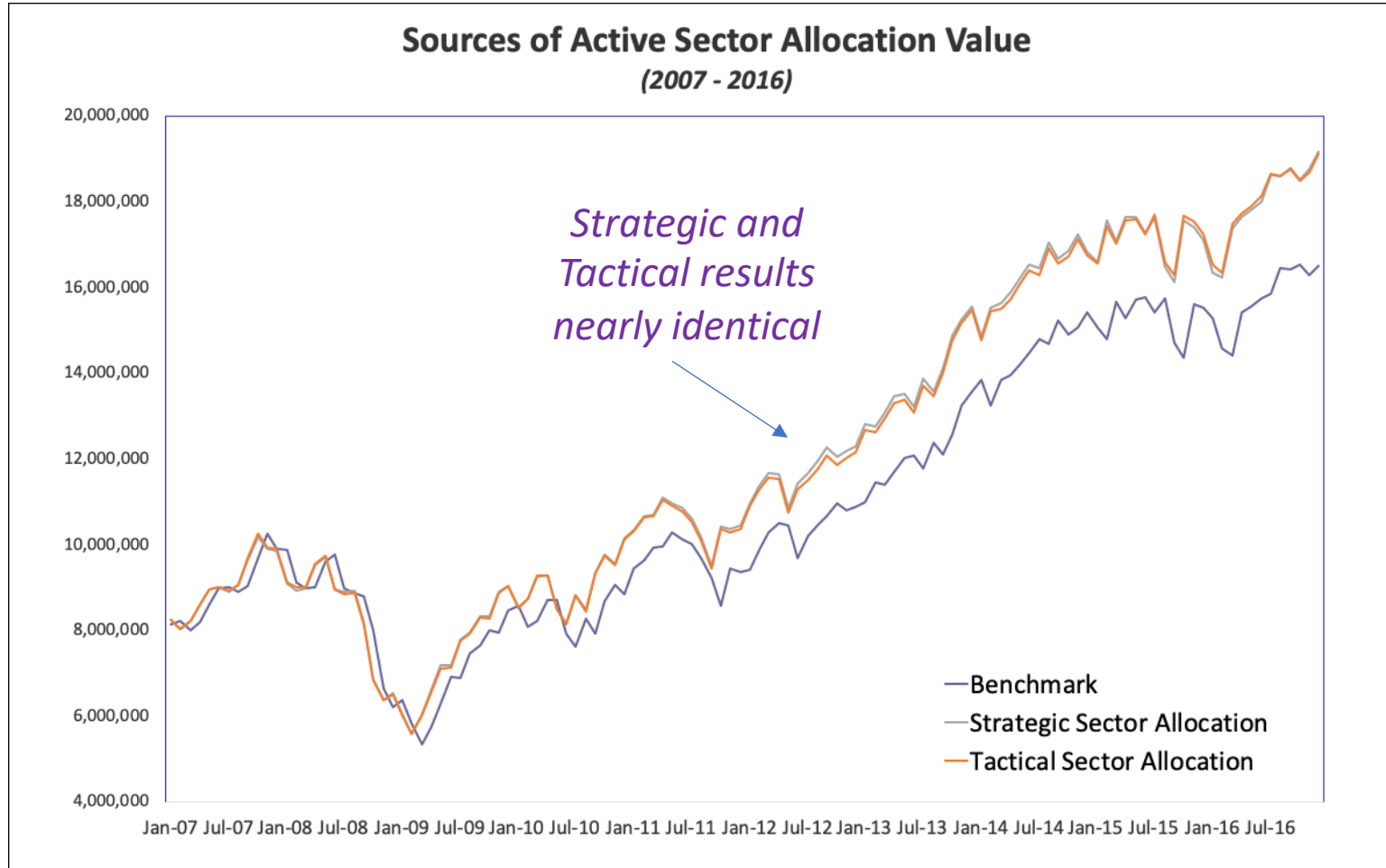
Sector Strategy Outcomes:

- Fewer severe "weak links"
- Highly-correlated to index

Evaluating Decision #2: *Strategic Sector Allocation*

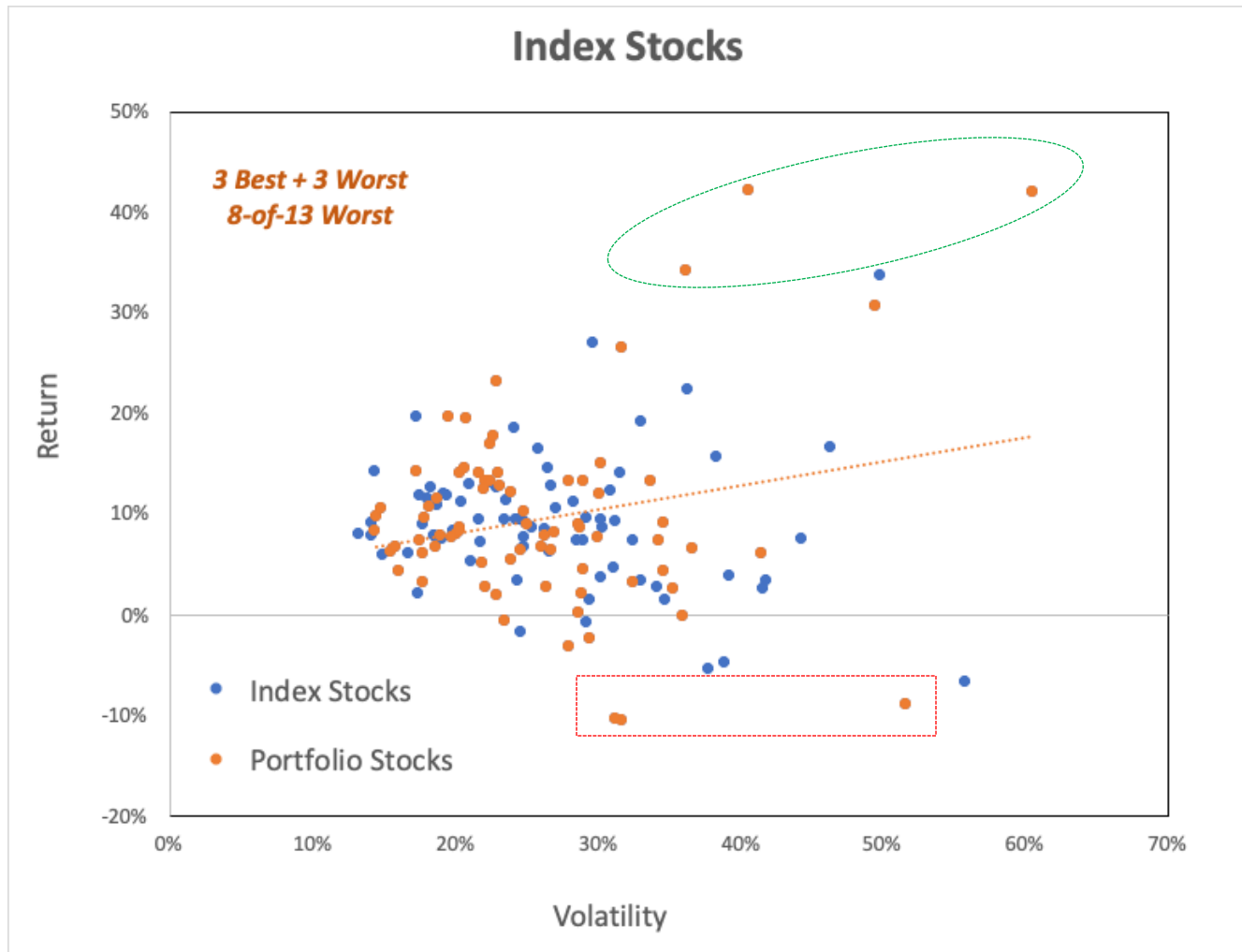


Evaluating Decision #3: *Tactical Strategy*



Decision #3 Added NO Value

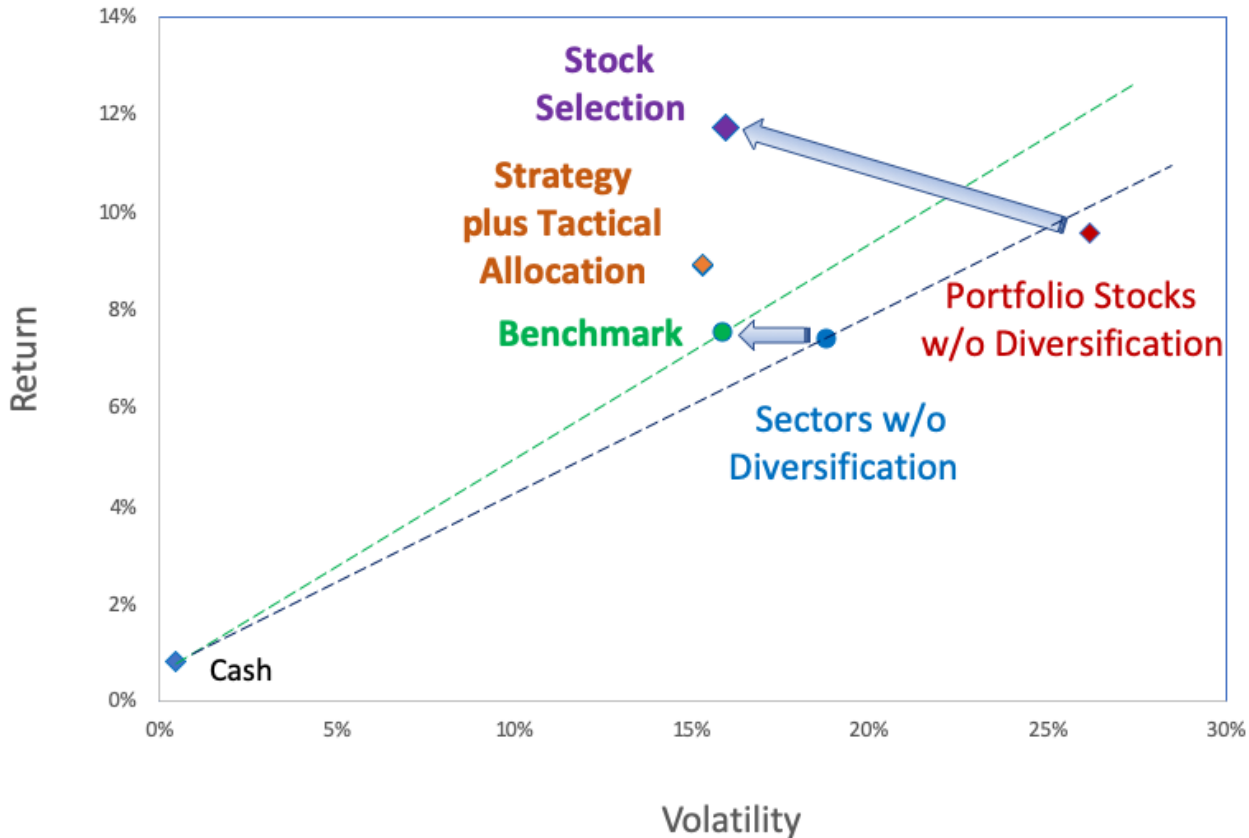
Decision #4: *Selecting Stocks from Benchmark*



Portfolio holds 3-best and 3-worst Stocks

Portfolio stocks seem more conservative

Results of Investment Decisions
(Portfolio of 75 Large Stocks 2007 - 2016)



Benchmark provides some diversification

Portfolio strategy added return while lowering volatility risk

Stock selection was greatest source of alpha

Evaluating Results of Each Decision

Investment Decisions	Total Return	Volatility	Return Enhancement	Volatility Increase
Cash	0.80%	0.46%		
Benchmark	7.55%	15.82%	6.76%	15.36%
Strategy	8.93%	15.29%	1.38%	-0.53%
Tactical	8.90%	15.27%	-0.03%	-0.02%
Selection	11.74%	15.94%	2.84%	0.66%

- This is a total-return and total risk analysis
- One component of market return (*Beta*)
- Three components of active return (*Alpha*)

Decisions in the Context of Portfolio Return & Risk

Contributors (bps)			Contributors (%)		
	Volatility	Return		Volatility	Return
Market Return	15.66%	7.55%	Market Return	98.3%	64.3%
Active Return	0.28%	4.19%	Active Return	1.7%	35.7%
Total	15.94%	11.74%	Total	100%	100%

- This is an **additive analysis**
- Efficiency: ***equalizing percent contributions to Return and Risk***
- **Active return is much more efficient than market return**

Insight

Active management contributes to portfolio efficiency

Efficiency of the Active Decisions

Contributors (bps)			Contributors (%)		
	Tracking Error	Return		Tracking Error	Return
Strategy	0.35%	1.38%	Strategy	15.4%	32.9%
Tactical	0.38%	-0.03%	Tactical	16.6%	-0.6%
Selection	1.55%	2.84%	Selection	68.0%	67.7%
Total	2.28%	4.19%	Total	100%	100%

- *Active process is nearly perfectly efficient*
- **Total** Allocation effect is efficient with 32% contributions
 - *Tactical Allocation subtracts from efficiency*
 - *Strategic Allocation makes up for inefficiency of Tactical decisions*
- *Selection is major source of excess return (as expected)*

Interaction of the Active Decisions

Correlation of Active Effects		
	<i>Selection</i>	<i>Tactical</i>
Tactical	0.24	
Strategy	-0.24	-0.16

- Active decisions are "*diversifying sources of alpha*"
- Strategic allocation provided greatest reduction of active risk

Analysis of Decision Efficiency

Efficiency Analysis of Investment Decisions	Percent Contribution to Total Volatility	Percent Contribution to Total Return	Efficiency Rating
Selection	5%	24%	19%
Tactical	0%	0%	0%
Strategy	-3%	12%	15%
Benchmark	98%	64%	-34%

- Holistic performance attribution analysis – focus on Decisions
- Strategic Sector Allocation and Stock Selection are the two most efficient contributors to portfolio return and risk

Current Approach to Performance Attribution

1-Month Performance Attribution Analysis	6/30/07	6/30/07	Portfolio Weights	Benchmark Weights
	Portfolio Returns	Benchmark Returns		
Basic Materials	6.73%	8.32%	5.29%	3.94%
Communication Services	5.24%	3.46%	8.35%	11.71%
Consumer Cyclical	-0.85%	-1.90%	11.33%	3.85%
Consumer Defensive	1.12%	-0.08%	12.45%	9.68%
Energy	4.66%	5.57%	10.71%	13.81%
Financial Services	-2.67%	-2.69%	10.74%	20.18%
Healthcare	-3.14%	-3.63%	13.03%	13.95%
Industrials	-0.78%	0.10%	6.23%	7.42%
Technology	4.35%	1.85%	19.02%	13.94%
Utilities	-2.76%	-5.25%	2.86%	1.52%
Total	1.34%	0.56%		

- Emphasis on **current period**: explains short-term performance
- Focuses on a **single factor**: tactical allocations
- *Selection is simply a residual*

Traditional Performance Attribution:

Does This Describe Your Process?

1-Month Performance Attribution Analysis	Allocation Effect	Selection Effect	Total Excess Return
Basic Materials	0.10%	-0.08%	0.02%
Communication Services	-0.10%	0.15%	0.05%
Consumer Cyclical	-0.18%	0.12%	-0.07%
Consumer Defensive	-0.02%	0.15%	0.13%
Energy	-0.16%	-0.10%	-0.25%
Financial Services	0.31%	0.00%	0.31%
Healthcare	0.04%	0.06%	0.10%
Industrials	0.01%	-0.05%	-0.05%
Technology	0.07%	0.48%	0.54%
Utilities	-0.08%	0.07%	-0.01%
Total	-0.01%	0.79%	0.78%

- Excess return driven entirely by stock selection
- Major contributing sectors: Financials and Technology
- Major detractor: Energy

Would you like to...

- *“Put your best foot forward”*
- *Reduce the complexity in your reports*
- *Increase clients’ understanding of your process*
- *Show them pictures that “tell the story”*
- *Show them numbers they understand?*
- ***Let your value proposition shine***

It’s easier than you think!

Please contact us for a consultation.

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