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top-down or bottom-up?

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Of all the arcane investment arts, perhaps the best known but least understood are 'top-down' and 'bottom-up' investing.

In the first of a series of investment-led informer articles, Graham Bentley, Head of Investment Marketing, Selestia and Skandia MultiFUNDS, explains why elements of each philosophy should contribute to the ideal portfolio.

Essentially, 'top-down' and 'bottom-up' are portfolio construction strategies, where the hierarchy, or 'family tree' of asset classes and sectors, is approached from different directions to formulate a route to 'investment nirvana'.

That hierarchy starts (depending on your point of view) from a single point at the top (the market), the decision process drops down to the major asset classes (equities, bonds), each branching further to geographical regions (UK, US etc.), deeper into the stock exchange classification system which comprises economic groups (Cyclicals, Financials), then stock sectors (Insurance), sub-sectors (Life Assurance) and finally companies (Norwich Union, Prudential).

take it from the top

As the names suggest, the top-down (TD) school starts at the top, and makes decisions at each level of the hierarchy by applying a series of filters along the way. How can we best split our exposure to equities versus bonds? What weight in which regions? Should we focus on Financials and be underweight in Oils? What Financials sub-sectors are likely to benefit most next year? Which stocks in those sectors stand to benefit most? This is a strategy intended to mitigate risk; the specific risk attaching to each security can be ignored, because what the manager is deriving his return from is market risk - the probability that an asset class or sector, as a whole, will behave as the manager expects. Stocks are then selected from this sector 'short-list'.

TD adherents are better known as Tactical Asset Allocators. The logic being that it is easier to assess the likelihood of a particular asset class or stock sector doing well (because there are relatively few of them) as opposed to a stock (of which there are over a thousand in the UK market) doing well independently of its sector, ie due to specific risk alone. TD managers are attempting to beat their benchmark by taking bets higher in the decision tree.

build from the bottom

Bottom-up (BU) investors simply do the reverse. They start at the bottom of the tree; for the stock picking manager, asset and sector allocation take a back seat. In his or her view, the specific risk is what drives their decision making. Exceptional returns can only come from exceptional stocks; by definition then, this group of managers seeks out the 'exceptions to the rule'.

In essence, risk is secondary - returns are the primary goal of the BU manager. He or she simply chooses the companies they think are the most likely to see increases in share price over the next 12 months, given the forecast for general market conditions.

Moreover, some BU devotees believe they can get better returns and reduce risk relative to the market. They will set out a number of screens through which companies' vital statistics are run - generally known as 'Quant' - and select a group of possible stocks, from which the final selections will be made following in-depth research, company visits and so on. Many stock-picking managers abhor a benchmark – a tracking error requirement means the manager is tied to an index to a degree, for this to be adhered to requires a top-down approach almost by definition.

is either strategy better than the other?

It can be argued that TD investing is mainly associated with global, multi-asset portfolios. A manager running a UK Equity fund has nowhere else to go

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other than UK Equities (although in practice UK All Companies funds can invest 20% of their assets in overseas equities), so how can he be anything other than BU?

Well, TD does not have to start with asset allocation. A UK equity manager could have a TD approach, in the sense that he/she will first consider the current point of the economic cycle, then think about the sectors which tend to benefit most at that point, and finally choose stocks which are both representative of a particular sector and happen to be well-run companies. This explains why so many UK funds look alike; their benchmark and tracking error requirement means they have to mirror the FTSE All Share to varying degrees.

It could be argued that being one of the crowd reduces the risk to a manager’s reputation - nobody minds you being wrong if everyone else is. On the other hand, a TD manager is not necessarily benchmarked - he or she may believe that most companies cannot do well if their particular sector is out of favour, no matter how well-run the company is. TD investors therefore pay more attention to where the market appears to be heading. Beta - a measure of a share’s sensitivity to market returns - is considered by some to be an excellent predictor of returns. A TD investor might choose high beta stocks in a rising market and low beta stocks in a falling one.

If you are not going to stick to the inherent discipline provided by the TD philosophy, then you have to think differently to be successful. Exceptional returns are the exception by definition, hence doing what everyone else does cannot produce anything other than average returns. For this reason, BU investors do not like markets where there is low volatility and a narrow distribution of returns, because when stock returns bunch together, there are fewer stocks worth buying and fewer ’dogs’ for others to buy in error.

The opportunities for out-performance are therefore much rarer. To beat the market you must either know something that other investors do not, or be prepared to accept a risk which others will not. An undervalued stock may not be mispriced - the ’cheap’ stock may simply expose you to a risk other than market risk. If the majority are not brave enough to accept this risk, then the share could offer bigger returns for the braver investor.

This is where BU comes into its own. Some examples of BU funds such as Special Situations, Recovery, Value etc. are synonymous with the extremes of performance. However, these funds may be volatile relative to both their peers and the market, simply because in an efficient market the only way to achieve higher returns is to take higher risks.

It is precisely when markets have high levels of uncertainty that BU investors have the greatest chance of success. >>

Unfortunately this is also when the majority of investors' appetite for risk diminishes and why so few investors actually get those fantastic returns. They wanted to avoid risk, which is why asset allocation has become the primary investor strategy over the last few years.

strategic asset allocation

Unfortunately, the academic work which underpins the success of asset allocated portfolios is somewhat misunderstood, and furthermore is noticeably absent from the process used by managers of global multi-asset 'managed' funds.

Brinson et al's seminal paper 'Determinants of Portfolio Performance'* seemed to indicate that over 90% of returns could be explained (in the statistical sense) by asset allocation. As less than 5% of portfolio returns apparently resulted from stock picking, the implication was that an emphasis on stock selection was a waste of time - the hard work had been done via allocation of assets to the major asset classes via a mathematical concept known as mean variance optimisation. This is where assets are combined so as to cancel out their respective peaks and troughs, in order to create a risk-return profile which matches that of a particular client or group of investors. Risk is assessed first, and the returns are simply those associated with that level of risk. It has taken time, but particularly following the catalyst of the bear market, the concept of asset allocation has taken off in the UK.

Unfortunately the Brinson findings have, in my view, been widely misinterpreted. The study explained the variation in returns, not the returns themselves. There is no question that portfolio returns can be significantly affected by stock/fund selection. One only has to compare two identical asset allocations populated by best and worst funds respectively to see the potential difference in returns. However, as we have seen above it is extraordinarily difficult to identify the winners and losers in advance, because typically we will not take on stock specific risk in the periods where it is most likely to be of benefit. Generally, people's fund selections are something of a curate's egg - good in parts - to the extent that taken in the round they are average. However, within the context of a mean variance optimised portfolio, the chance of 'unforced errors' through unnecessarily strong bets on a particular asset class can be avoided.

Thus, I suspect that the ideal portfolio construction process should exhibit elements of both schools. A mean variance optimised asset allocation matched to a client's particular risk profile can be populated with funds which (Small Cap and Special Situations, for example) are run on a bottom-up basis. Alternatively, within that same asset allocation strategy funds can be selected which combine both bottom-up and benchmarked funds.

'the ideal portfolio construction process should exhibit elements of both schools'

*'Determinants of Portfolio Performance', Gary P Brinson, L Randolph Hood and Gilbert L Beebower, Financial Analysts Journal, July/August 1986:39-44

minimising asset allocation 'bets'

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Through our investment tools we offer portfolios generated following the tenets of Modern Portfolio Theory ie they are matched to the client's risk appetite. Advisers can populate the asset allocation with funds from the wide range available or can delegate the selection to individual funds/managers through selecting single sector MultiManager investment funds.

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