Our 7 Core Investment Principles

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Every investor starts their journey into the investment world via their core beliefs about investing, or via their investment principles. Those beliefs may not be written down. They may not be right. But the very first investment decision made reflects those core beliefs. If you are a day trader, your core principles are implicitly that you know something others don't and you can act faster than others. Most large institutional investors have similar core investment beliefs, but what they often miss is reflection on their own capabilities relative to the efficiency of financial markets.

We believe that the financial markets are very dangerous places in which to be a participant. They are massive, complex, highly efficient in processing information and incite very high levels of emotion to get in the way of rational thought. The market is Goliath and most investors think they are David who can slay the market with their insights. Our unstated principle not included below is that we do not think we are David. We must live with this monster Goliath and recognize how powerful and unpredictable they can be. With this core underlying context, we set out our 7 core investment principles.

1.

Long-term investors out-perform short-term investors

Most investors are not able to ignore short-term declines in value and, as a result, react by cutting risk, generally selling low. Those same investors often take comfort from short-term increases in value and buy more at high prices. So most investors buy high and sell low. This is a by-product of natural human emotional behaviour. We want to be the buyers when they are selling low and the sellers when they are buying high. But we are generally staying focused on the distant horizon and not reacting to short term valuation moves or views on near term events. The long term is less crowded with other investors and therefore presents more opportunities that don't already reflect all information. The distant future is more uncertain and can be more possibly exploited by deep fundamental research focused on the long-term.

2.

Multi-asset class portfolios continue to reap benefits from diversification

Diversification is the simple principle of "more eggs in the basket" combined with each egg having a different driver behind what will break it. There is no return without risk in investing, but different asset classes' returns are rewards for taking different risks. Asset classes conceal true underlying risks, so diversification must be achieved at both the asset class and market beta level looking through asset classes to "risk betas" to ensure true diversification is achieved in the portfolio. The underlying risks of asset classes include equity risk, inflation risk, interest rate risk and credit or default risk. As a result, the returns from all 13 asset classes that we embrace vary in their correlations with each other and therefor, the right combination of asset class exposures will deliver a higher return for a given amount of risk than does any one asset class.

3.

Formulating an appropriate risk budget based on expected return targets and sticking to it will deliver the best long-term investment results

This is our "no market timing" principle. Investors should not increase or decrease the overall level of risk in the portfolio based on a belief that they can get into and out of the financial markets in a way that avoids declines and only participates in the rising periods. We pay asset managers to time their entry and exit from specific assets. But at the overall portfolio level, risk should be held constant. The key measure of risk is the collection of the underlying four betas that we described above. We hold these exposures constant and when markets move their relative values away from our desired mix of market risks (betas) we rebalance portfolios back to targets, often reaping outperformance from buying low and selling high.

4.

Extreme market environments occasionally provide tactical asset allocation opportunities that can enhance investment returns

In rare cases, the emotional drivers of markets may take specific asset values well below or well above their intrinsic value or to the value that markets will ultimately settle to in less volatile markets. This can happen at the asset class level (one or more of the 13 asset class's valuations fall outside of a reasonable range of valuation (usually two or more standard deviations). This can also happen at the sub-asset class level, where, for example, high yield credit is cheap relative to leveraged loans, or European equities are cheap relative to North American equities, etc.). Very few opportunities present themselves in any one year, but in extreme market environments, a handful of properly sized over-weights or underweights to asset classes or sub-asset classes can contribute a small but significant amount of outperformance.

5.

The vast majority of active asset managers do not justify their fees as their returns can be replicated with low-cost passive instruments (e.g., ETFs)

This was perhaps the most significant belief that motivated us back in 2001 to launch Partners Capital. We observed that most actively managed funds (private and public) did not outperform the appropriate risk-matched benchmark over a long (> 5year) period of time. What we observed was that "most alpha, is beta in disguise." This means that asset managers generally mistake alpha for just taking more risk in up markets or less risk in down markets. Private equity, private debt and property are no different. Most outperformance can be tied back to higher than average risk, whether it is leverage, sector, management, or operational risk. This does not rule out investing in active managers, but rather underscores how difficult it is to find true outperformers. We set out to be the firm that found the exceptions to the rule because we had the right lens and the right tools.

6.

Deep fundamental research by a highly specialised asset-class focused team is required to find and access the rare active managers who can outperform in the future

Finding the asset managers who are the exceptions to the rule (#5 to the left) requires rigorous quantitative analysis to understand if the returns are from manager skill or just market exposure paired with qualitative judgments on whether this skill is sustainable. This principle naturally follows on from #5.

7.

A portfolio constructed with a small set of exceptional managers for "alpha" and passive low-cost instruments for market exposure or "beta" is the most efficient use of the fee budget

Again, this principle naturally follows from #5. It is not likely that we, or any institutional investor will at all times have access to truly value adding asset managers in all asset classes. Accordingly, passive exposures will have a role, that may come and go. There is a cyclicality to alpha which reflects the coming and going of investors on the back of surplus or lean periods of outperformance (lean meaning few managers have most of the alpha). In our opinion, properly constructed, such a portfolio can deliver 2-3% of outperformance per annum over the market, on average over the long-term.

Successful investors “live and breath” their core investment principles

The greatest value of core investment principles comes from never forgetting them. Investment success is driven by the proportion of decisions we get right. We believe that we will get more decisions right by always referring back to these as we make each and every investment decision.

These principles guide us most prominently to our investment strategy and portfolio construction. These principles are what have had us embrace the endowment style of investing which has three key legs to it, in its very essence. Number one, the endowment model says to target high static risk at the overall portfolio level which is made possible by virtue of our long investment horizon (we can weather short term volatility) and our disbelief in market timing of risk exposure. Secondly, the endowment model embraces multi-asset class diversification with a bias toward private asset classes where value can be added by the right asset owners. And finally, we believe in allocating capital to entrepreneurial owner-operated investment management teams who are fully aligned with us.

As a result, our strategy today has us managing multi-asset class investment portfolios which invest in almost every major asset class. We build each client’s portfolio from the ground up, customised to a client’s investment objectives, risk constraints, time horizon and liquidity needs. Every client portfolio reflects these 7 core principles, but we do not believe in ‘one size fits all’ offerings will meet the needs of sophisticated endowments, foundations or family offices with specific investment objectives and constraints.

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