Five Questions

Episode Three | Who's On Your Team?

Pete: Hi, my name is Pete Mann, and I'm the President and Co-CEO of Grayhawk Wealth. Welcome to the second season of our podcast, Five Questions, which will see one partner at Grayhawk, paired up with another to touch upon relevant topics as they relate to the economy, investments and generally what's happening in the world as we see it. Sometimes we'll invite special guests to join us so you can also hear their views. With me today is Greg Gipson, Grayhawk's Chief Investment Officer, who is responsible for shaping our investment philosophy and portfolio strategy. Welcome, Greg.

Greg: Thank you so much, Pete. It's great to be here and very well done on getting through "Grayhawk Greg Gipson", it's always a challenge for me to get through.

Pete: The Triple G. Well, Greg, I'm really excited for our discussion today because I think one of the things that a lot of people don't spend enough time on is that around manager selection. So, as we both know, the decision and due diligence required to entrust someone with your capital should be a tireless and process driven responsibility. Too often people chase recent performance or take at face value the advice they received from someone else without doing the work necessary themselves. This leads to suboptimal returns. It also doesn't allow for an understanding of when a manager is no longer adding value. So, I thought today we could start really at the top of the house and maybe you could please discuss the manager selection process and why it is so important.

Greg: Absolutely, Pete. And for our astute listeners, you will remember two episodes ago. So, our season two, episode one we spoke about volatility and returns, and you will recall that we discussed how asset allocation, so how you allocate investments to capital appreciation and income generation is the primary driver of the variability or volatility of your returns. We pointed out most importantly implementation or who you invest in is the primary driver of your returns. Our network affords us access to some of the most exclusive and sought-after investment opportunities across public and private markets. Our due diligence of managers and their strategies follows a disciplined and rigorous approach to assessing investment, merit, operational structure and consistency of philosophy and process. This due diligence process follows four steps. **Step one:** determine the beta or market exposure that we, Grayhawk are looking to gain access to. So, what does that mean? That means that our investment research team, our focus is on defining what areas of the market we want to gain exposure to. So, think of something as simple as U.S. Small-Cap value.

Step two: Assess the largest universe of managers available to us around the globe. So again, you know, we like analogies, so think of it as a funnel. We want to fish from the largest pond in the world. We want to access local expertise. And to do so, we incorporate proprietary modeling, data science founded in machine learning, when we look at managers and assess these opportunities to determine specific fundamental attributes that we're looking to gain exposure to.
Step three: More of a qualitative assessment of the manager. This is when we will speak directly to the manager, assess them along dimensions such as people for classify and process. But all of the work that we've done prior to this really allows us to have more of an evidence-based discussion rather than a storytelling exercise.
And finally, **Step Four:** is determining the appropriate strategy that enhances the risk and return of the overall portfolio. And I stress that because what are we trying to accomplish? Our goal is to build a great portfolio. It is not necessarily to build a portfolio of great managers.

Pete: So, the analogy, the sport analogy that I've heard people used before is this idea of an NBA All-Star team putting together the five best players. But if they don't complement one another, the ability for a team to play together, much like the Toronto Raptors basically have done this year, is a great example of an organization and a thought process around the construction, more so than the individual star, the collection of individual stars, is that fair?

Greg: Absolutely. Team before individual.

Pete: So, one of the things that many investors are obsessed with is short term performance. They never recognize that very short-term cycles can often be an aberration. Good and bad. And so, they kick to the curb the minute that things turn sour, and they fall in love with you, the minute that things are going well, and they can be in incredibly short periods. When you are going through the manager selection process, how much does short term performance play a role in this?

Greg: Well, maybe I'll touch a few comments on short term performance. And yes, I would reiterate, you know, it reminds me of my hedge fund days, right? You're only remembered for your last trade. So, it can certainly be frustrating but maybe if you just think of markets. So, if you look at S&P TSX Composite in Canada, or the S&P 500 in the U.S. Over the last 30 years, the TSX has compounded 11 times, the S&P 500 has compounded over 18 times. But in that 30-year period, if you look at daily returns, the average return is barely positive, the number of positive days is barely better than a coin flip. When you go out to a month and three months, you start seeing a little bit higher numbers, but again, barely better than the coin flip. So short term performance, as you mentioned, I love the word aberration, I was going to use it. You stole it, but I'm going to use it again. Aberrations and more importantly, emotionally reacting to aberrations has proven to be very challenging to generate long term, consistent returns. When we assess opportunities, we're looking at strategies, consistency, and persistency of return relative to their benchmark. We want to see a component of their return, the alpha or the stock selection that increases late consistently throughout time. It's very important when you assess managers to split out the beta. So, remember, that's the exposure that we Grayhawk want, with the alpha which is what we're looking for managers to provide. What I would say about short term performance is we do monitor this across all of our strategies, and we do so not so much to micromanage our managers, but rather to use it as an indicator of any structural changes going through the market. So again, I get to make another allusion back to when we talked about the froth versus the undercurrent. Often where we'll see market inflection more quickly is in our active managers.

Pete: So, if you look at the most important factors as you digest the manager selection process, what would they be? Maybe you could if you wouldn't mind taking us through them, maybe in priority.

Greg: Sure. So, I'm going to stick with our theme of having lists that will make it easy. Whenever we assess an opportunity, we want to answer three primary questions. The first, how is it managed? We want to understand the consistency of an investment approach and ensure that managers do not deviate from their style or philosophy. Question two, how has it done? So again, looking at the consistency of both outperformance over time, but also improving levels of outperformance over longer periods of time. And three, how does it fit? Is this opportunity additive to the overall portfolio, either in risk or return space?

Pete: So, for that component of how has it done what is the process by which you are looking at that as it relates - Because that becomes the very core focus of almost everyone as we just talked about short, intermediate, long term, how did it do? And maybe you could tie that into the first component, which was really what you were talking about around style drift because often you'll see managers do better than their peer group in an environment where things shouldn't look as rosy as they do.

Greg: Great point. And this really goes back to the philosophy and the philosophy that we believe in a decomposing or gaining exposure to beta and to alpha –

Pete: - And beta, just for clarification being the market return or market exposure you wish to have whatever it may be.

Greg: Correct. And think of it this way for if you're looking at US equity managers and you want to hire a manager to gain exposure to the S&P 500. If you hired a growth manager in the depths of 2008, you would see fantastic returns. But if you made that decision, it's important to define that you've made a bet on exposure on beta, right growth versus the broad market plus alpha. I think that's one of the key components that people often miss is that style a manager has, and comparing that to a completely different entity, it's an apples and oranges comparison. You know, our focus is defining very specific forms of beta again, such as Russell 2000 value. Then we want to go out and find managers who manage a Russell 2000 value strategy but can add consistent and persistent alpha from their stock selection.

Pete: Great. That's really helpful. So, looking at this from the other side, just like the great stock pickers of the world are, right between 55 to 58% of the time, it's really about their determination or conviction on how right they are that really defines their alpha as you were describing earlier. Obviously, we have the same challenge that exist within managers themselves. So, can you talk a little bit about what happens when a manager doesn't work out? What's the process for exiting or onboarding a manager and how do we try and do that maybe the most effective way possible?

Greg: The decision to exit a manager and I would include reduce the exposure to a manager as well. So, there's changes in the weights in the portfolio would be driven by a number of different reasons. One could be flows within the overall portfolio, changes in the type of data that we Grayhawk want to gain exposure to. But if I read your question correctly, Pete, I think what you want to know is how fast do we fire people? You know, I firmly believe and I'm upfront with all of our managers, our process is higher, slow, fire fast. So, to be included in our strategy takes a relatively long period of time. To be exited from our strategy, takes much less time. And the way that we assess that exit is similar as the way we assess opportunities coming in, disciplined, transparent to the managers and done consistently across the board. We certainly understand there may be times in the market that are challenging for some strategies, that may lead us to reduce our exposure to the strategy, but if our view is that the market is not favorable to these strategies and may not be favorable to these strategies in the short to medium term, we will fully exit a position. We do not have any relationship with any manager where we are compensated by them to invest in their strategies. So, for us to hire and fire it's very much as we like to say, pieces on a chessboard. We will bring them in as we need them and exit them when we do not.

Pete: That's great. That's really helpful. One of the cringe-worthy comments I know that you hear often is that we are referred to as a manager. It is part and parcel with the industry overall, but it is quite different from how we approach things. Would you maybe explain a little bit about how we see our role in the overall process of capital allocation and relationships with clients?

Greg: Well, I will have to tell you, you know, again, I like this. Here's my top three list of terms that were referred to as, Manager, certainly better than number three, which is allocator The number one term that I think is most appropriate for what we do at Greylock is investor. And I prefer the word investor because when you think of the word manager, you often think of what the industry thinks of as manufacturer. So, you are creating strategies that invest in individual securities, equities, fixed income. Everybody is independent until they're not. And it seems to me that the typical connotation of independence, at least here in Canada, that would refer to non-bank affiliated in our view, independent is even a smaller bucket than that. The ability to make advice separate from managing strategies. That level of independence is actually quite rare. Both in the industry broadly and specifically in Canada. Our only source of revenue as a firm is from our families. We do not accept any form of compensation from any manager anywhere in the world.

Pete: So, for our final question of the day, we are living through some of the biggest inflationary times that has happened in the last 25 years. And I would be curious to know what is a good or a service that you buy regularly that has gone up the most in price in the last 12 months. And it cannot be gasoline.

Greg: Well, you know, to be honest, gas would be the easiest answer. But from a personal perspective, it's actually the cheapest because I only just recently filled up my tank since last November. So, working from home has at least had that benefit. But outside of gas, everyone knows I like to talk about food. I like analogies with food. That is really the pain point for us as a family. Because there are two things that we unequivocally cannot live without as a family. Well, three, because Internet was a given. So outside of the Internet, the two things the family cannot live without are bread and cheese. And it is I don't even bother. I don't even bother looking at it at the grocery bills anymore and we're healthy eaters. So, fruits and vegetables as well. But we would gladly give up fruits and vegetables to keep cheese and bread.

Pete: Well, that's it for the third episode. Of Season two of Five Questions. I'm Pete Mann, President and Co-Chief Executive Officer of Grayhawk. On behalf of my partner, Greg Gipson, our Chief Investment Officer, we want to thank you very much for listening. We'll be back in two weeks with a new episode. This podcast is for informational purposes only. It is not meant to be relied upon for investment or tax advice. It is the opinions of those on the podcast and does not necessarily reflect the opinions of Grayhawk Wealth. If you'd like to offer any feedback or pose a question for inclusion on the podcast, please reach out to our Chief Experience Officer, Allison Comeau at acomeau@grayhawkwealth.com. See you in a couple of weeks!