

The portfolio construction “two-step” is not a dance – despite how it may sound. The two-step that we practice at Quadrant instead refers to the two fundamental steps involved in constructing a proper investment portfolio. While our two-step may not be as fun as the dance variety, it provides the basic framework that guides our investment process at Quadrant.

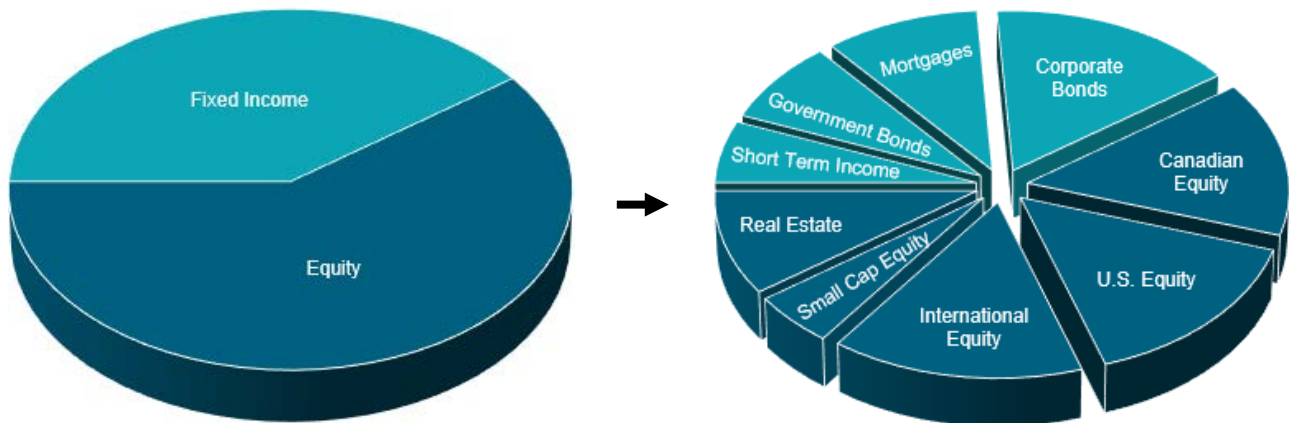
The two fundamental steps in the portfolio construction context are asset allocation and asset class manager selection. This article will introduce both components, but the primary focus will be on manager selection. Asset allocation will be covered in deeper detail in the future.

Step 1 – Asset Allocation

Asset classes are groupings of investments with similar characteristics. In the broadest terms, the two main asset classes are equity and fixed income. Equity represents ownership of an asset or business and is most commonly accessed through the purchase of common stocks. Fixed income represents loans to various borrowers and is most commonly accessed through the purchase of bonds. In other words, equity represents owners and fixed income represents lenders. As owners, equity investors are entitled to the profits and growth of an asset or business while as lenders, fixed income investors are entitled to predetermined interest payments and the return of lent capital after a set period of time.

Risk and return characteristics of these two broad asset classes are typically very different. Equity generally has higher long-term returns compared to fixed income, but is more volatile in the short term. By combining equity and fixed income, a portfolio can be balanced according to an investor’s risk profile and return objectives.

Equity and fixed income asset classes can be further refined into sub-asset classes, of which there are many variations across the risk/reward spectrum. The chart below illustrates how a 40% fixed income / 60% equity portfolio might look when breaking it down into sub-asset classes.



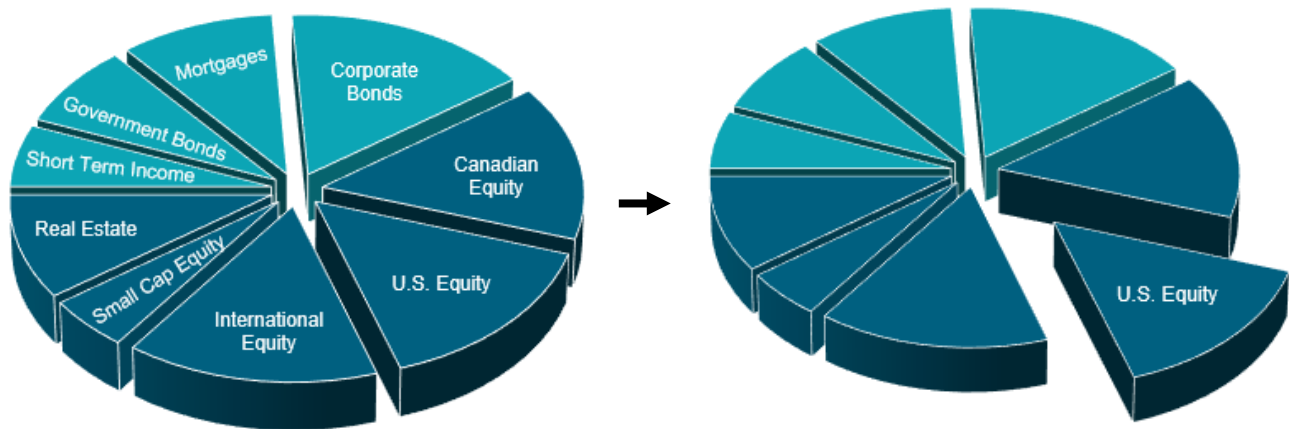
The determination of asset allocation is the first step in the portfolio design and construction process as it provides the structure and fundamental risk/reward characteristics of the portfolio. Asset allocation is ultimately driven by the overall objectives, time horizon, income requirements, liquidity needs, and risk tolerance of the investor. While sub-asset classes in a portfolio may be added, removed, or adjusted from time to time for a number of reasons, the asset allocation, or “asset mix”, of a portfolio is not intended to change frequently. An Investment Policy Statement (IPS) will outline the specific asset allocation and rules-based process for rebalancing the portfolio as asset classes naturally drift from their target weights over time based on performance. The IPS process is

fundamental to each client’s portfolio at Quadrant – discussed in greater detail in our past newsletter [The IPS is Your GPS](#).

As noted, a more comprehensive review of the asset allocation process at Quadrant will be the subject of a future article.

Step 2 – Asset Class Manager Selection

The second step in the portfolio construction process is deciding how to best access each sub-asset class.



At Quadrant, rather than select individual securities (stocks, bonds, etc.), we focus on selecting best in class investment managers for each sub-asset class. This creates a structural separation that ensures full objectivity when making investment decisions. It also gives us the ability to make changes to managers if we deem it necessary. Our clients gain access to institutional investment managers, which are often unavailable to individual investors, and it allows us to leverage the extensive resources of these investment management firms for the benefit of our clients.

For certain sub-asset classes, we may decide that a “passive” manager/product is the better choice as opposed to an “active” manager. A passive mandate is designed to replicate a market index associated with a sub-asset class while the goal of an active mandate is to provide superior risk-adjusted performance – for example, higher returns for a similar level of risk, or similar returns for a lower level of risk. Passive mandates can be suitable for sub-asset classes that are beneficial to the overall portfolio, but have a limited choice of active managers, and/or where the differences between active managers are minimal.

The manager selection process at Quadrant involves in-depth analysis from both a quantitative and qualitative perspective. While each sub-asset class is unique in terms of its exposures and characteristics, the selection process is similar. The following discussion explores the process and various tools that we use.

Manager Universe

The manager selection process always begins with identifying the universe of available investment managers and products pertaining to a specific sub-asset class. This can number in the hundreds or thousands depending on the particular market segment in question. Quadrant gathers this information in a number of ways, including internal research, industry network, and the following key institutional database services:

- eVestment – an institutional database service that collects and aggregates information from more than 17,000 strategies. This is the industry “gold standard” of investment manager databases.
- Bloomberg – a provider of in-depth financial market data and portfolio analytic software relevant to the investment industry.

Quantitative Analysis

Quantitative analysis allows the large amount of sourced manager data to be assessed and compared consistently. Each manager in the universe is analyzed and evaluated through the use of various risk and return metrics.

Quadrant utilizes an internal quantitative model to assist with the ranking of managers within a respective manager universe. This allows us to objectively identify the most attractive options from a risk-adjusted standpoint. We are unbiased towards investment style (growth vs. value) or “active vs. passive” managers, but we do emphasize downside protection compared to peers. All managers are assessed through the same quantitative lens designed to identify best-in-class managers.

Managers that rank in the top quartile according to Quadrant’s quantitative model are screened based on additional key criteria to further refine the list of prospective managers. For example, performance history and liquidity characteristics are important considerations.

- Performance history – a manager must have a reasonable amount of actual performance history to be considered. A minimum “track record” of five years is required, with a preference for eight or more years.
- Liquidity – in most cases, daily liquidity is preferred. Less liquid or private investment alternatives may be considered at times depending on the asset class and investor circumstances. For example, a core U.S. equity mandate should offer daily liquidity while certain real estate mandates may offer less immediate liquidity.

Qualitative Analysis

Top quartile managers that have been screened for key criteria move into the qualitative analysis stage. Qualitative analysis requires going beyond assessing risk and return metrics – this stage of the process “lifts the hood” in order to examine and understand the manager and strategy on a deeper level. Key aspects considered include:

- General information – ownership structure, history of firm, financial strength, culture.
- Personnel – experience and education of key staff, staff turnover, succession planning.
- Investment approach – philosophy, consistency in approach over a market cycle, inputs, diversification.
- Research – internal vs. external research.
- Performance – realistic expectations, consistency.
- Reporting – quality of information, compliance reporting.
- Other – internal controls, regulatory, trading and back-office support, client turnover, assets under management.

Detailed information relating to all of the above items is provided to Quadrant in a fulsome due diligence questionnaire from a selection of prospective managers. The due diligence questionnaire allows Quadrant to compare the managers in a consistent manner.

Manager Meetings, Recommendation, and Investment Committee Approval

After the quantitative and qualitative analysis process has been completed, Quadrant will meet with a selection of prospective managers considered to be the best candidates. This allows Quadrant to meet with the key decision makers of each strategy and cover any remaining questions resulting from the prior due diligence stages.

The Investment Management team at Quadrant will work collaboratively and create a final recommendation report that is provided to Quadrant's Investment Committee. The Investment Committee provides an independent layer of oversight and has final approval authority on all investment decisions.

Ongoing Due Diligence

All managers utilized at Quadrant are continually monitored and evaluated. Some of the ongoing review measures include:

- Monthly performance reporting (compared against relevant benchmarks).
- Quarterly diligence questionnaires.
- Quarterly attribution analysis to understand drivers of performance.
- Quarterly quantitative analysis of each manager universe for peer comparison.
- Periodic update meetings with managers.

This ongoing monitoring ensures that our asset class managers continue to merit inclusion in Quadrant portfolios.

The Portfolio Construction Two-Step

To summarize, the portfolio construction two-step at Quadrant is:

- Step 1 – asset allocation
- Step 2 – asset class manager selection

Each of these two steps require considerable planning, analysis, and ongoing diligence. An appropriate and diversified asset allocation combined with best-in-class investment managers are key to the successful construction and management of client portfolios at Quadrant.

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