The Journal Interview

Bas Leerink, CIPM

is heading the team responsible for the on boarding of new clients for PEARL, Ortec Finance's solution in the field of performance measurement, attribution and risk. He holds Master degrees in Physics from Leiden University, and in Investment Management from VU-University of Amsterdam. He is a member of the committee that sponsors the GIPS Standard in the Netherlands. Bas holds the CEFA designation.

David Spaulding: Let's begin with some background about yourself.

Bas Leerink: I was born and raised in Luxemburg. I moved to the Netherlands to continue my education at the Leiden University where I received my Master's degree in Physics. During my studies I followed a track called Science Based Business that orients the students to work in the business after university by introducing them to marketing, finance, project management, etc. You're also given the opportunity to perform an internship at a company, which I did at Ortec Finance in the Investment Performance Department where I was first introduced in the field of performance measurement and attribution.

After graduation I was offered a position at Ortec Finance as a consultant and I gladly accepted. During my internship, I felt that with Ortec Finance I found a place that would allow me to develop myself further and apply my analytical skillset to real world problems. With physics you apply models and try to understand the results from those models to get a grip on what is happening in the physical world. With performance measurement and attribution you apply the same steps to get an understanding of the impact of investment decisions and market movements on the generated return.

To increase my knowledge of the market our clients operate in, I continued my education at the Vrije Universiteit in Amsterdam where I completed a Master's in Investment Management. As part of this master's I wrote a thesis which was the basis of the Dietz award winning article that Gerard van Breukelen and I wrote. What I particularly liked was that we took the most common attribution model (Brinson-Fachler) and looked at the weak points of this model when combining multi-period results in one analysis. By using models you can gain valuable insights, but it is at least as important to know and understand the strong and weak points of the model to fully understand the insights the model brings.

During my years as a consultant I was involved in the implementation of the PEARL system, Ortec Finance solution for performance measurement and attribution, for both asset owners and asset managers. In 2014, I became a member of the GIPS country sponsor committee of the Netherlands.

DS: Your role at Ortec Finance has changed a bit; please provide us some insights.

BL: In March, our company reorganized to better align the organization with the growth potential we see in the market. Our company is now formed by eight solutions, each responsible for bringing one solution to the market. For our solution, this is the PEARL system, focusing on the field of Performance Measurement and Attribution.

During the past two decades, we have grown our client base steadily. We value our clients highly and find it very important to provide them with the support they require. At the same time, we see that our new version of PEARL 8 attracts a lot of attention in the market. To ensure that the onboarding of new clients impacts the support of our current clients as little as possible we have restructured our client facing team into two teams. The Global Client Servicing team is responsible for providing the support to our existing clients and the Global Implementation team is responsible for the onboarding of new clients. In my new role I have the honor of leading the Global Implementations team which is responsible for the onboarding of new clients.

DS: It seems to me that Ortec is a bit unique, as you have

a fairly strong presence in the asset owners space. How do the needs of asset owners compare to those of asset managers?

BL: Our client base is a mix between asset owners and asset managers. On the asset owner side we serve pension funds, insurers and sovereign wealth funds. The asset managers on our client list are typically those that have a large institutional client base and want to differentiate themselves by tailored or specialized investment strategies that truly add value for their end clients. In order to support those strategies they need specialized tools for performance measurement and attribution. So having complex investment strategies in place is a common denominator among our clients.

But to differentiate the two groups; asset owners primarily use our performance reports to get a better understanding of the quality of their investment decision process which is typically structured top-down. They also tend to allocate a considerable amount of assets in non-listed investments. Asset managers tend to be more focused on client reporting, efficient workflows, and a stable production process. But having said this, we also work with asset owners that manage the majority of their multi-billion assets in-house, and have performance teams that are twice the size of a typical asset manager. So it's not as black and white as you might expect it to be.

DS: One area that is often of interest is the ability to provide attribution across multiple levels (*e.g.*, portfolio, sector, sub-sector). Is this of equal interest for asset owners and managers, or do you find that one has stronger preference for it?

BL: The aim of every model is to present a story and traditionally the story for asset owners was different from the story for asset managers. Asset managers have traditionally more "flat" decision processes where Asset Owners often have a layered decision structure with different people being responsible for different decisions. The main investment decisions for asset managers are, for example, sector allocation and stock selection where for asset owners they are asset allocation, currency and duration management over multiple asset classes and manager selection.

However, in the last couple of years, asset managers also started to include the more traditional asset owner type of decisions with the introduction of fund-of-funds where they add value through management of the asset class allocation or by implementing overlay strategies for their clients. For those asset managers we see the need arising for more complex evaluation techniques, including the top-down analysis, especially for fund-of-fund analysis where next to managing the asset class allocation, the manager is also responsible for investing in managers who have different benchmarks than the benchmark selected for asset class management. We see that decision analysis is required where the added value of benchmark-mismatches can be measured.

Still, we see that asset owners have a greater interest in attribution across multiple levels, and especially the extension to decision-based attribution which provides a framework that allows for a consistent evaluation of a layered decision process which includes strategic and tactical allocation decisions and overlays. The top-down decision-based attribution model can be combined with bottom-up models such that there will be one consistent set of (attribution) reports that cover every single investment and underlying decisions. Organizations can use this information to identify their strengths and weaknesses. They can also monitor the amount of (ex-post) risk involved in each decision and compare this with their ex-ante expectations or risk budgets. This is of course very powerful input for their forward looking investment decisions.

DS: What are some of the challenges in the asset owner space that aren't so present for asset managers? And, vice versa.

BL: Let's start with what I see as the main challenge for both asset managers and asset owners, and that is data. Performance measurement requires data, and for both, getting the required data and having processes in place to ensure that all the data is present and correct is the main challenge. The need to have tooling that supports the processes to handle this challenge is comparable. The frequency of the processes may vary from daily for asset managers to weekly or monthly for asset owners, but both need checks that notify the operator when data is missing, incomplete, or when strange events occur that require special attention.

A challenge for asset managers which is not so present for asset owners is that it is very important for an asset manager to have scalable and relevant analysis simultaneously. Since many different investment funds need to be evaluated, you would like to have a number of template analyses that provide the required insights for a large number of funds, and which can easily be tailored to cater to some special requirements for specific funds. For asset managers, it is important that good processes are in place to ensure that analyses that are provided to the organization are complete and correct.

Asset owners have a higher need for more tailored evaluations that provide accurate insight in specific complex investment decisions. Evaluation models for illiquid investments, overlay strategies and a coverage of all asset classes are required. At the same time, an analysis framework is required which allows the asset owner to see the added value of every decision, or group of decisions and the impact on the total fund return.

DS: One topic that has gotten increasing attention is ESG: Environmental, Social, Governance. Please explain what you are seeing from your clients and prospects.

BL: In the last couple of years, incorporating ESG in the investment process has taken an enormous flight. Where five to 10 years ago some asset owners started by excluding certain investment types like tobacco or weapon manufacturers from their investment universe, nowadays, exclusion lists are common practice for any investment organization. The extent to which E, S or G is incorporated in the investment process is a choice of each investor. There are different ways to incorporate ESG in the investment process, which can roughly be classified into the following categories:

- Exclusion (standard) – Based on certain E, S or G, criteria certain investments are excluded from the investment universe.

- Best in class - Based on metric investments, are ordered from “good” investments to “bad” investments, and the good are over weighted and the bad are underweighted within the portfolio. To avoid sector biases (financials have a far lower carbon footprint compared to energy) the ranking can be done within the sector.

- Engagement – Companies are engaged to improve on their E, S and/or G. This can be through shareholder voting strategies or by actively engaging the companies.

- Thematic and Impact investing – With those investment strategies, only companies that actively improve the E, S and/or G broader than only the company in itself are included.

All of our clients include ESG in at least one of the above-mentioned categories in their investment process. The market is becoming increasingly aware of ESG risk’s and opportunities with climate-related risk in particular. Many of our clients have aligned their investment process to the Paris agreement or by signing the UN Principles for responsible investments. The first step in the investment process where this is included is portfolio construction where ESG has been in the spotlight for the last couple of years. It is only natural that a bit later the market is going to look for ways to measure and evaluate the impact of those decisions.

DS: Is ESG far enough developed that firms can obtain proper performance attribution and other analysis, or is more needed?

BL: I do believe that if you incorporate ESG in your investment processes it is important to also monitor and evaluate the investment process accordingly. Traditionally, the investment process had the goal of generating returns and evaluating the investment process against a “market” represented by the benchmark. Most, if not all, of the traditional performance evaluation tools that a performance measurement specialist has available are focused on the evaluation in the return space. With the inclusion of ESG in the investment process, at least one if not multiple additional dimensions are included. These do form additional challenges, because the improvement in those dimensions are often difficult to measure, especially in the short-term. However, since including ESG in the investment process has now become main stream, including ESG in the evaluation of the investment process also has to become main stream.

For some, in the earlier mentioned categories in which ESG can be included in the investment process (Exclusion, Best in class), the evaluation is already possible and used, where for others (Best in class, Engagement and Thematic) it is not so straight forward and more is definitively needed, although this probably requires us to move away from the traditional performance evaluation in the return space and move to the evaluation of improvement in the E, S or G space.

One of the main challenges is the availability of good quality data to support the investment process. In the last couple of years, more providers of data in the ESG space became active, providing many different metrics. For some areas (mainly in the Environment space) the metric to use is still understandable, for example, the carbon footprint of a company. For others in the Social and Governance space this is less clear. Companies are not very open about, for example, their use of child labor or about the practices for their products (*i.e.*, cars) to perform exceptionally well during tests. Therefore, the metric will most likely only be updated negatively after a problem occurred, making it less attractive to use in the portfolio construction and evaluation.

DS: We recently learned that large US investors are giving some thought to reducing their ESG restrictions. This seems to be driven by the need for increased alpha. There appears to be some evidence that ESG mandates may result in underperformance relative to non-ESG. If this is all true, does that not bode well for ESG? Some have suggested that ESG is a “fad.” Might this come to be true? What are your thoughts?

BL: I believe that it is important for any investment organization to periodically rethink their strategy and determine whether the strategy is still a sound one in the current market. Incorporating ESG in your investment process can be done for two reasons. The first is to better align the investments with the goals of the “asset owners,” the investors in the case of an asset manager, and the participants in the case of a pension fund. The second reason is that you believe that including ESG in the investment process can lead to additional outperformance (alpha).

There is some research that supports the thought that alpha can be generated by including ESG. If that is what you are looking for than it is best to not assess an aggregated ESG score, but to select only the material issues for a company/industry sector. There is abundant empirical research out there that indicates that it is possible to “do well and do good” (see, *e.g.*, Friede, 2015). Please note that the research is done in a very similar way as the research that was executed roughly five to 10 years ago that showed that factor strategies, like momentum, generates alpha. Later studies showed that the momentum factor is not always present, especially in the period after including factors in the investment process became main stream leading to overvalued factors.

Since ESG has attracted a lot of investments in the last couple of years and the investments are probably based on very similar metrics, I do believe that there is a high chance that ESG investments are currently expensive and therefore might be overvalued. Especially if you go for an Exclusion or Best in class approach. Therefore, if you consider investing in ESG for producing outperformance it is important to have a sound alpha thesis and have a thorough understanding of how the outperformance is intended to be generated. In this light I can see that early adopters who invested in ESG for generating alpha now consider a divestment strategy and “cash in.”

Getting back to the first reason for including ESG in the investment process, namely to better align the investments with the goals of the “asset owners,” this is a trend that I expect to stay. Generating outperformance in the low-yield environment with passive alternatives for many asset classes is not easy. Many “asset owners” do find it important that their money is used to “do good” next to generating a market return. Rethinking how best “to do good,” which can lead to a reduction in ESG restrictions, should be part of any sound investment decision process.

DS: Please share with us other information you think our readers will find of interest.

BL: The main challenge seen within our professional industry is the availability of data. Each investment category in itself has it challenges, from selecting the relevant metric from a large universe of available metrics in the case of ESG data or the lack of timely available data in the illiquid space. A huge amount of our time goes into ensuring that the data is available to perform the measurements that we would like to do in a timely manner such that the reports are available for the organization.

The most interesting part of our work is to interpret the results and to understand where the organization adds value. In which areas are we as an organization strong in adding value, and do the numbers support this? For this knowledge of the investment processes is key and therefore performance analysts should be involved in an early stage when new investment processes are considered. The performance analyst than has the time to arrange for adequate evaluation of those processes. Determining those analysis is probably the most exciting part of our job.

As the one responsible for the implementation of our tooling for the performance analyst I see it as one of the biggest challenges for us to help our clients to perform the first task, ensuring that all relevant data is present, in an efficient manner and to provide them with the knowledge and the tools to perform the second.