

## Extracting more juice from yesterday's heroes - a glimpse into the future of Portfolio Management

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### Introduction

Development and adaptation are present in any dynamic system where the factors of supply, demand and competition for scarce resources are in play. It can be led by a change in the operating environment, whether imposed from outside (think of a comet hitting the Yakutan peninsula) or inside (think of the global changes in human demographics driving global warming). The survivors invariably fall into three groups: those who are fortuitously adapted to the new environment, those who don't see it coming but can change to embrace it anyway, and those who pre-empt or participate in bringing about changes for their own competitive benefit. The last of these is a characteristic usually reserved to describe human behaviour!

What does any of this have to do with the investment management industry?

Our industry is in continual development. The forces driving this development may be enforced upon us by regulation, changes in demographics or a change in the level of sophistication of consumers. They may also be driven by the competitive pressures between participants who, as a group, shape the environment in which we operate. Within this framework, many fund managers are realigning their businesses to meet these challenges.

There will be winners and losers in this game.

Importantly, these developments have significant implications for future product sets and how they are used by investors and advisors. Our glimpse into the future requires a quick review of the environment – what are the factors driving developments in our industry and what are the likely implications for portfolio management, investment product and investors?

### Driving Change – The Forces of Demand

Much has been written about demographic changes within developed nations and the need to ensure dependency levels remain economically sustainable – that is, that the economy can in fact afford a higher proportion of potentially asset rich but non-productive individuals. In Australia, solutions to the resulting general funding issue come via the Superannuation Guarantee and the move to fund previously unfunded liabilities through vehicles such as the Future Fund. These measures support the continued growth of our industry. It is important to recognise, however, that they do not necessarily provide for individual security in retirement for all participants.

The Defined Benefit to Accumulation migration over past decades has presented a number of challenges for individuals, and has largely driven the growth of the advice industry. As future retirees generally must

rely (at least in part) on an income stream derived from their investments, each one has two interrelated questions to answer in regard to their intertemporal consumption problem:

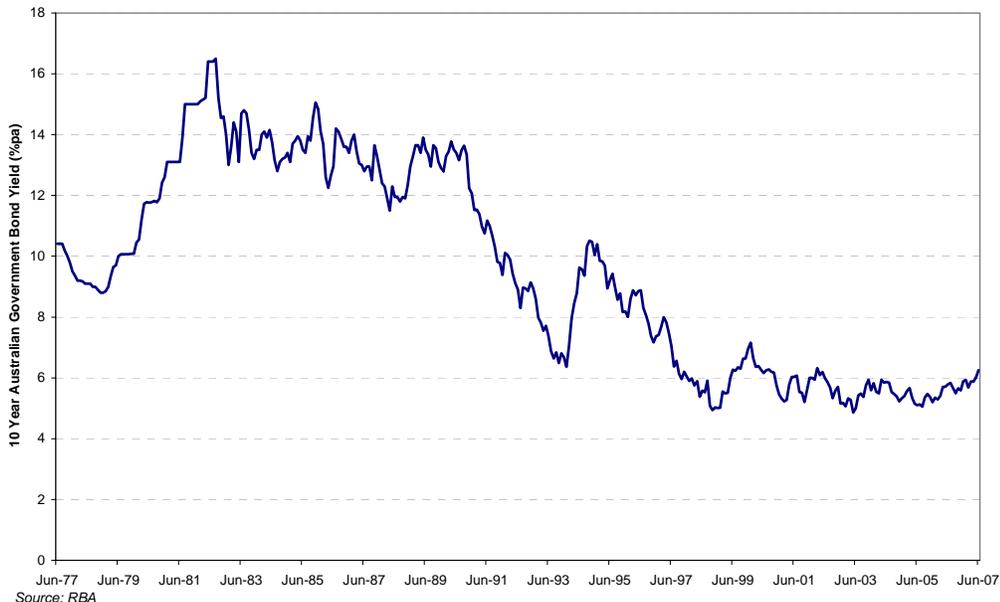
- How much is enough in retirement savings? – related to both the level of contribution and the portfolio returns in the accumulation stage.
- In retirement, how should investors arrange their affairs (i.e. investment portfolio) in order to draw an appropriate income stream?

The naïve approach to dealing with these issues has been a reliance on the equity risk premium: save as much as possible, invest in the growth assets and alter the investment strategy as retirement approaches to an income based strategy with capital preservation. This logic leads to a fundamental question about the sufficiency of investment returns in general, and yield from traditional investments in particular.

Long term expectations of equity market returns are significantly lower than the 25% levels achieved over the past four years<sup>i</sup>.

On the latter point, the high and growing global demand for yield, as more investors move from accumulation to disinvestment stage, has helped to drive down the available returns on traditional yield based investments. Figure 1 shows the decline in yields on Australian bonds to the steady but low yields received in recent years.

Figure 1: Australian Bond Yields: the last 30 years



The recent collapses of Westpoint, Fincorp, ACR and Bridgecorp highlight that miracle cures do not exist. Many investors were retirees looking for higher returns with capital stability. These returns only came with a higher risk of loss which investors did not understand or which they were prepared to bear in the search for sufficient income returns.

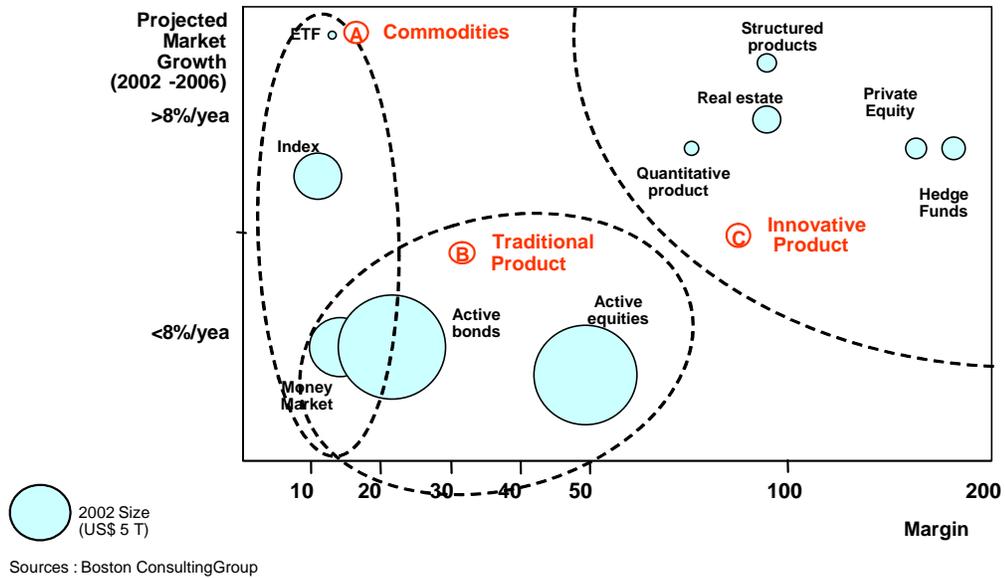
In short, where will future returns come from and how can we ensure they are sufficient to fund investment objectives?

Driving Change – New Intermediaries

These questions are a focus for an increasingly sophisticated advisory industry, and an emergent sophisticated mezzanine segment including superannuation funds and platforms. They drive a constant demand for product innovation and value, and also dramatically impact the evolution of the broader product landscape.

Sophisticated allocators increasingly look for best of breed components for fit into their broader portfolio solution for their clients. These may be products which provide cheap market (beta) exposure, maximise alpha or provide access to niche or specialist market exposures. Projections made by the Boston Group<sup>ii</sup> around the demand for these segments in the future are telling. This research is presented in stylised fashion in Figure 2, which shows the projected growth in demand for index, traditional (coupled beta and alpha) products and niche (alpha or beta) products in the future relative to the margins for those products.

Figure 2: Growth Projections from Boston Consulting Group



In addition to the search for the best components, allocators also increasingly look to funds management participants to provide input into portfolio design or to provide comprehensive portfolio solutions, using internal and sometimes external components. This is sometimes described as the “New Balanced” development. A more appropriate label is “Multi-asset” or simply “Portfolio Solution”, of which traditional balanced products are a small and diminishing sub-set. An example at the institutional level is that of liability driven investment, which we will explore in a case study later in this paper.

Driving Change – The Forces of Supply

The evolution of investment management technology and techniques has been continual since Markowitz<sup>iii</sup> began the modern portfolio theory revolution and Jones<sup>iv</sup> created the first hedge fund. Innovation has also

seen the delivery of these techniques in new products matched to evolving investor requirements. In some cases, these new products are delivered ahead of those requirements. For example, the ongoing emergence of new competitors on the supply side, including the boutique phenomenon in Australia, and the migration of trading and risk management techniques from bank trading desks to mainstream investment management.

Most recently, developments in the hedge fund industry have seen a convergence with mainstream investment managers on a number of levels, including areas of financial backing, operations and risk management. Importantly, hedge fund products now compete with traditional investment products for global flows from pension and superannuation funds as well as individual investors.

This presents challenges for mainstream industry participants. For investors, advisors and fiduciaries there are non-trivial questions around transparency, liquidity, high performance fee structures, complex investment processes and securities and offshore product laws (to name a few). This is assessed relative to the opportunity cost associated with foregoing an alternative source of return.

For traditional investment managers, the challenges are potentially greater: competition for funds flow, for talent and perhaps even for relevance in an increasingly sophisticated and bespoke investment market. This competition takes place under a scenario where fees and lack of legacy favour the new-comers.

These factors have led to a significant amount of realignment activity within the traditional funds management industry. The winners of the future have been described by McKinsey<sup>7</sup> as at-scale players (including the index houses), focussed-asset providers (which include specialist, high conviction and high alpha groups) and multi-boutiques (conglomerations of smaller independent fund managers). Nowhere here is a reference to the traditional multi-sector fund management businesses. This thinking is apparent to most fund managers globally, and consequently the industry is undergoing a significant realignment. For traditional investment management businesses, this focuses on a move into higher alpha or alternative/niche beta segments where demand is expected to be high and margins will be the greatest.

#### A Glimpse into the Future – Active Extension into Higher Alpha

Before exploring this further, it is appropriate to seek to understand alpha itself. Alpha represents the value added by skilful investment management. It is measured relative to a relevant market exposure (benchmark). It is important to note that true alpha is rare and difficult to produce (while traditional betas are cheap).

The information ratio (IR) has become a standard in the assessment of successful active investment return outcomes. It is essentially a measure of risk-adjusted return:

$$IR = \text{Alpha} / \text{Portfolio TE}$$

A higher information ratio means more alpha per unit of active risk. A consistently high information ratio is used to infer the existence of investment management skill. Statistical tools are available to make this inference so that we avoid confusing excess returns (which may come from luck or structural biases in portfolios) with true alpha. While the information ratio is useful in decomposing ex-post outcomes, in this form it does not provide insight into how to improve investment outcomes.

An alternative perspective is provided by the fundamental law of portfolio management, first introduced by Grinold and Khan<sup>vi</sup>. It states that the information ratio (which measures the success of an investment program) is related to investment skill (formally the information coefficient) and the opportunity to use that skill (breadth):

IR = Skill \* Opportunity to use Skill

$$IR = IC * \sqrt{Breadth}$$

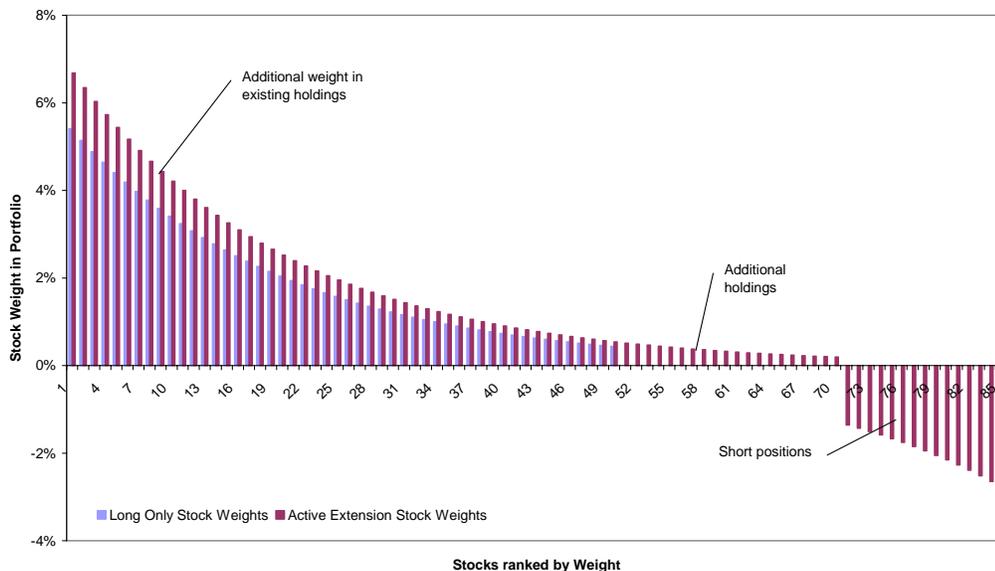
The fundamental law has some significant implications for the application of investment skill. Skill without opportunity is unrewarded. Skill applied with limited opportunity is sub-optimal. For a skilled investment professional, superior outcomes will result by using skill in the broadest possible opportunity set.

To secure the best outcomes relative to risk, we must provide the most skilled investment talent with as much opportunity as possible. Another way to view this is: removing constraints from traditional mandates has the effect of increasing the available breadth for use by skilled investment talent, and therefore the potential outcomes.

One such constraint is the long only constraint usually imposed in traditional equity mandates. The long only constraint creates an asymmetry in the investment manager's ability to use skill because s/he can not take advantage of extreme negative views effectively. Removing this constraint where there is investment skill allows an active extension into the higher alpha space, known as short extension into the long-short product space.

The basis of long-short funds is illustrated in Figure 3. The key advantage of the approach is to leverage the ability of the manager to use skill to take advantage of underperformers and allow positions to be maintained that are net short. This is achieved through stock borrowing and subsequent short sale. The sale proceeds can be used to invest more in the expected out-performers, retaining an overall 100% net market exposure, either by fund new holdings or increasing exposure to existing overweight holdings as has been illustrated in Figure 3. The result is what has become known as 130:30, 1X0:X0 or active extension products.

Figure 3: Active extension example portfolio weights



This structure is not substantially different to a traditional active fund. The strategy is already popular with the large quantitative managers<sup>vii</sup>, but fundamental managers are increasingly adopting this approach to develop new higher alpha product.

Broadening the opportunity allows a manager to increase their information ratio for the same level of investment skill (IC) and produce higher returns for given levels of tracking error. There are costs to shorting which limits the extent that the information ratio can be improved. This approach provides leverage to the skill (desirable) without needing to leverage the capital (unnecessary) which occurs with some hedge fund structures.

The transformation of traditional managers to utilise more hedge fund strategies is not limited to short extension. Other examples include the development of less constrained long short products where the manager may also vary market exposure, the decoupling of active decision making from market exposure entirely (pure alpha or market neutral strategies), the importation of derivative techniques, the use of financial leverage, and others.

It is in the interest of both the manager and clients for those with real skill to focus on delivering alpha products in different forms:

- Managers are able to grow their business and share in the benefits generated by their skill.
- Clients benefit from a more efficient allocation of risk in their portfolio.
- Clients with sophisticated allocation models will reduce their total costs for the same level of alpha and beta.

### A Glimpse into the Future – Alpha as Yield?

Modern investment techniques allow alpha to be generated independently of market exposures. Additionally, alpha and beta can be decoupled and repackaged into portfolio solutions: derivatives allow equity alpha to be swapped over bond (or cash) beta or indeed any alternative source of alpha over an equity beta (an equitised strategy). There is a strong argument for viewing a suitably stable source of alpha as a potential alternative to traditional yield product.

### A Glimpse into the Future – The Search for Alternative Sources of Return

The potential to extend the product range does not belong to any particular sector of the market. There is capability across asset classes to introduce portfolios with higher active return components. The emphasis used to be on the ability of equity managers to generate a high level of out-performance. However, income asset portfolio managers can produce stable active returns and have an ability to leverage their risk exposures through derivatives such as futures and swaps.

Fixed Income assets have typically been sought for diversification purposes and to provide stable income. Lower yields and a continuing need for diversification of portfolio risk has intensified the search for alternative product in this space. Traditional thinking around what constitutes yield and where it can be sourced is under challenge. Some hedge funds and structured credit products have been able to fill some of this gap.

A number of recent developments highlight the case: Investors are turning to longer term inflation hedging assets such as infrastructure, niche property or even intellectual property exposure as an alternative beta source of yield<sup>viii</sup>.

### **Case Study 1 – Where Demand Meets Supply: Insurance Portfolio Solution**

As an example of the themes in this paper, Colonial First State Global Asset Management recently tendered for a large insurer with inflation linked liabilities. The requirement was to match the liability profile while allowing the generation of alpha at levels significantly above those that can be achieved in traditional fixed interest or inflation linked segments. The solution involved bringing together a number of specialist components (some of them extended from traditional processes as described above) into a sophisticated portfolio solution, which included:

- The separation of alpha and (inflation linked) beta management;
- The generation of synthetic inflation linked exposure, freeing up available funds to allocate more broadly in the portfolio;
- The removal of a range of traditional constraints imposed by the mandate which acted as limiters to translation of investment management skill;

- The introduction of additional sources of higher alpha, including fixed interest strategies such as nominal yield curve, duration, alternative credit and currency strategies implemented either physically or synthetically over the inflation linked benchmark;
- A wider tactical asset allocation opportunity set among underlying exposures, as well as the opportunity to adopt a relative view between these nominal exposures and the synthetic inflation linked exposure; and
- A performance based fee to align the investment manager with investor success and reduce the cost to investors unless value is added to the portfolio.

The significant innovation arises as a result of the linking of the themes of component extension and portfolio solution. Individual components of this solution are under development as stand alone future products. This was done within a framework which links strategic product development, investment design and extension with internal funding of new initiatives within a specialist Group in the business.

#### Case Study 2: Blends for the Retail Investor

In early 2007, Colonial First State Global Asset Management undertook a similar proposal with a large retail administration platform which realigned its underlying fixed interest managers, illustrating these trends:

- Increase in the return target of the active managers with a greater breadth of value add opportunity; and
- Utilisation of index management to obtain low cost beta.

This approach provides the opportunity for retail investors to benefit from the institutional developments in portfolio management. Opportunities here will expand with future products providing scope for planners to more easily target separate high alpha active return streams and market exposures. Financial advisors will need the skill to both determine the appropriate allocation of alpha and beta, and to select the appropriate active manager to provide the alpha.

#### Conclusion – Where to From Here?

In the future, demand will increasingly focus on best of breed components and the ability to deliver them in tailored and sophisticated portfolio solutions. The portfolio management response will be products that are a blend of the current offerings of hedge funds and traditional managers rather than having two separate buckets for traditional and alternative products.

Among traditional multi-sector investment management businesses, the winners will be those who have an active program of development executed strategically by a dedicated and focused development engine which is strongly mandated and can allocate funds to support its activities.

There will remain a strong need for client focussed intermediaries, both financial advisors and superannuation funds. The challenges for advisors to stay abreast of developments and an increasing level of sophistication are high. The individual reward for being successful will be just as high.

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<sup>i</sup> ASX200 + 25.1%pa four years to June 2007. Long run expectation is only 9%pa. source *Colonial First State Global Asset Management*

<sup>ii</sup> Boston Consulting Group (2006) "Playing the Long Game: Global Asset Management 2006"

<sup>iii</sup> Markowitz, H. M. (1952). Portfolio Selection, *Journal of Finance*, Vol. 7, Iss. 1, p. 77-91.

<sup>iv</sup> [www.awjones.com](http://www.awjones.com)

<sup>v</sup> Mckinsey Report "The Asset Management Industry: A Growing Gap between Winners and the Also-Rans" 2006

<sup>vi</sup> Grinold, Richard C. 1989. "The Fundamental Law of Active Management." *Journal of Portfolio Management*, vol. 15, no. 3 (Spring):30–37.

<sup>vii</sup> For example, State Street Global Advisors claims that in excess of \$10bn is already invested in its 'Edge' Strategies

<sup>viii</sup> See Dunstan, B 2007, 'Intellectual property looks smart', *The Australian Financial Review*, 19 Mar, and Patten, S. 2007, 'Colonial sings a new song' *The Australian Financial Review*, 15 May,