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THE NEW AGE OF INVESTMENT MANAGEMENT

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INTRODUCTION



Alan Brown

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oday's institutional investors want more than just fund performance from their investment managers. They also expect efficiency, innovation and easy access to information. While these growing requirements may present challenges to investment managers, they also offer opportunities.

At State Street Global Advisors (SSgA), the investment management arm of State Street, we are answering the demands of these investors with new products, strategies and technologies. As the world's leading institutional investment manager, we understand the value of long-lasting relationships with our clients – and the importance of providing them with ongoing “thought leadership”.

In this briefing, the last of three State Street-sponsored supplements in 2004, we examine ‘The New Age of Investment Management’. Our experts in the European market explore topics ranging from exchange-traded funds to the emerging bond market and quantitative manager performance. In addition, *Global Investor's* editorial team offers an objective, broad viewpoint on some of these trends.

We are pleased to present these perspectives to *Global Investor* readers and hope this special supplement inspires further thought about the future of investment management.

Sincerely,

A handwritten signature in black ink, appearing to read 'Alan Brown', with a stylized flourish at the end.

Alan Brown
Group chief investment officer, State Street Global Advisors

Mixing innovation with caution

► KEY ISSUES

Paul Allen introduces the main issues facing investment managers and finds much innovative thinking about ways to deal with the current languid state of markets.

The bear market of 2000-3 and the subdued conditions that have followed have raised many questions for the investment management industry, the answers to many of which are still being formulated. But, as the saying goes, necessity is the mother of invention and, against a backdrop of constrained returns and regulatory scrutiny, the industry is responding to the challenge with a mix of innovation and caution.

From the regulatory standpoint, while some initiatives are a reaction to the various scandals that have rocked the financial world, the political questions in Europe surrounding the issue of long-term savings and the desire for risk-free outcomes are also significant drivers of change.

In the UK, a major subject of debate is the relationship between institutional investors and their investment managers, around such areas as the unbundling of brokerage commissions and the remunerations of managers, says Sheila Nicoll, deputy chief executive of the Investment Management Association, the UK industry body. In response to many of these issues, the Financial Services Authority, the regulator, came out with Consultation Paper 176, which deals with bundled brokerage and soft commission arrangements, and is to be followed by a consultation paper setting out various rule changes in the first quarter of 2005.

Another big issue relates to corporate governance and shareholder activism. Debate centres on who has the right to vote in companies and the communication mechanism between companies and their investors, says Nicoll. In the UK the governance issue has been reviewed in reports by Paul Myners, a senior UK investment figure, and the issue is also under consultation

with the European Commission at present as part of the action plan 'Modernising Company Law and Enhancing Corporate Governance in the EU'. Add in UCITS III, Basel II, and accounting changes and the regulatory landscape starts to look pretty crowded.

Meanwhile, on the discretionary side, investment managers are reviewing their business strategies in the light of new opportunities not seen for some time, says Jonathan Clark, executive director of Citisoft, a specialist investment management consulting firm. "During the three years of poor market conditions, in order to maintain margins firms had to reduce cost and increase efficiency," Clark says. "While firms are still trying to reduce cost, there is now an increasing focus on the revenue end of the business, which I expect to see more of in 2005."

Generating returns for clients, and fees for the managers, in a stagnant market climate is a difficult proposition when relying on the index-based approach so prevalent in the 1990s. The talk therefore is very much around absolute return investing strategies, and ways to generate alpha.

This is sparking a revival of interest in the subject of asset allocation, says Rick Lacaille, chief investment officer of State Street Global Advisors in the UK. "Institutions need to take a dynamic look at their assets versus liabilities, rather than having a strategic benchmark that is reviewed every three to five years."

Peter Schwicht, head of European institutional business at JPMorgan Fleming Asset Management, says: "If the market just moves sideways how can investors, in an environment where liabilities are growing a lot faster than the asset base, generate the returns necessary to match the liabilities using index-type returns? "Therefore you see this strong growth of high alpha strategies. So asset managers' investment skills are becoming more important than a couple of years ago, where the beta was more important than the alpha."

But the focus is not just on maximising investment returns. Rather, in this new, more risk-conscious world,

Institutions need to take a dynamic look at their assets versus liabilities, rather than having a strategic benchmark that is reviewed every three to five years.

there is growing interest in the concept of liability-led investing, in which investment strategies are constructed so as to cover institutions' ongoing liabilities.

And when running asset/liability modelling studies, the outcome, generally speaking, means investing less in equities. Instead, there is a search for more diverse risk strategies, which is leading to interest in a wider range of asset classes.

Allied to that is what Robert Parker, deputy chairman of Credit Suisse Asset Management, refers to as "investor barbell", as investors leave traditional products, such as large-cap, core equities and government and investment-grade bonds, in favour of high and low risk products. "On the one hand they are going to the lower end of the risk spectrum—to cash-plus products, short duration bonds and enhanced indexation—and also to the other end of the risk spectrum, into emerging market equities, into small-cap/mid-cap equities, real estate, commodities and commodity-linked products, private equity and hedge funds," says Parker.

Hedge funds have been the particular talk of the town, and although this business is developing, some obstacles still persist. "A lot of institutional clients have been discussing investing in alternatives, but we did not see as much investment as clients said they were going to make, for example because of regulatory restrictions," says Anthony Finan, head of institutional marketing with BNP Paribas Asset Management.

Citisoft's Clark thinks there will be a surge of interest in alternative investments, and in particular hedge funds, in 2005. "At present, only 10% of pension funds invest in hedge funds, and of those only 5-7% of their assets are in hedge funds. Potentially then there is a huge amount of money available to invest in hedge fund," he says. However, the long-term growth of the sector remains open to question. "As hedge funds grow in size they lose their speed and responsiveness, and therefore the returns they are able to achieve," says Clark. "Also, as the number of managers increases, there will be an overlap in strategies which could cancel each other out."

Certainly, sustained popularity for hedge fund investing will depend on having strategies able to generate returns on a regular basis. "A lack of tolerance for failure in the short to medium term means some managers won't move into the hedge fund space," says State Street's Lacaille.

Yet Lacaille is sanguine about the sector's future prospects. "Hedge fund strategies are here to stay, and the concentration of alpha and skill they have brought to the industry is good," he says. And while hedge funds may not be generating the same returns they have in the past, they are still able to offer interesting returns over the long-only world, says Lacaille. In particular, because hedge funds have more freedom in the strategies they can use, they can produce better risk-adjusted

returns than long-only.

One idea gaining ground that can leverage long/short techniques is the use of portable alpha, whereby alpha returns earned in one strategy can be combined with the beta returns of an often unrelated benchmark index, which can be replicated using derivatives. "The idea of transferable alpha is getting more interest from a lot of asset management companies," says Finan.

Another source of interest, for those institutions that just want to pursue a long-only rather than long/short strategy, is the unconstrained investment approach, in which managers forget the benchmarks and simply look to invest to get the best returns possible, says Mike O'Brien, managing director, European business channel at Barclays Global Investors. "The ethos is, if it is a good stock then buy it."

Meanwhile, cost cutting and cost control remain important themes for investment managers. "In general, managers are looking to find greater efficiencies," says the IMA's Nicoll. "That raises questions for investment managers, such as are we a distributor or manufacturer? The focus is therefore on core competencies and outsourcing what is not."

Some of that may mean outsourcing non-core activities, or ones in which a firm does not have sufficient expertise, to third parties, whether the sub-advisory of mandates or business process outsourcing. For larger financial organisations, it could mean greater focus on the core asset management business, illustrated by French insurer AXA IM's recent decision to outsource investment operations services to State Street.

Centralisation is also high on the agenda, as investment managers seek to maximise their economies of scale. "Previously, firms operated on a regional basis, with lots of offices around Europe," says Nicoll. "Now they are looking to consolidate."

So in a world characterised by consolidation and economies of scale, is there a future for the small-to mid-tier investment managers? Rather, what seems likely is a polarisation of the market, between the very large, global managers, and the entrepreneurial boutiques, though with considerable volatility in the boutique space, especially among hedge funds, as firms open, close, merge and get taken over.

"For me it is a question of either being a specialist or you can generate scale to get a decent return, whereas if you are in the middle it is going to be difficult," says JPMorgan Fleming's Schwicht. "For the large global houses, the biggest challenge is to make sure you do not have only one investment process, because your risk is very high if something does not work, and to retain closeness to the client and convince them they are not just a small number in the overall universe of clients. But the benefit of size means we can invest in risk management and trading systems, we have good corporate governance, and basically we will be there tomorrow, which may not be the case with a small boutique."

Yet in this new investment era size will be no guarantee of success. Only those firms that have embraced the lessons of adversity, and continue to do so, can hope for a prosperous future. **E**

Paul Allen is a journalist who specialises in the investment management industry.

Pledging allegiance

► CLOSER PARTNERSHIPS

Pension funds are involving their fund manager partners much earlier in the investment strategy process in a bid to tackle deficits, finds *Paul Allen*.

While relationships in the institutional investment world may not be predicated on the longevity of a wedding vow, like marriage it is often easier to maintain connubial bliss during the richer days and for the partner-

ships to disintegrate or become devalued during the poorer ones. But tough times can strengthen and reposition a relationship, as long as there is a clear understanding, and common vision, of what each party expects to get out of it.

“There is nothing like low investment returns to focus the mind,” says Kanesh Lakhani, head of European marketing and consultant relations for State Street Global Advisors.

“Add to this the dramatic regulatory and accounting requirements and you can see why relationships between clients and their investment managers are changing rapidly. From a manager’s perspective, it would be nice to have long-term relationships where they can continue to cross-sell evermore of their services to clients. In the past, clients were often unquestioning of their managers or certainly not questioning them hard enough, so relationships endured for decades. What of the future? Times have moved on and, as with any relationship in life, fund managers will have to show not just commitment, but deliver consistently on their promises,” Lakhani added.

Indeed performance is the foundation stone of the relationship between investment managers and their clients. Yet hitting the requisite performance targets—the individual benchmarks of the investment managers and the overall returns for the institution—was clearly easier during the heady bull market days.

As Andrew Dyson, head of institutional business, EMEA Pacific, with Merrill Lynch Investment Managers in London, points out, when all institutional investors needed to do was invest in equities to achieve their goals, it was merely a case of finding the right equity manager or right fixed-income manager, because beta could be relied on “to get you where you wanted”. That is clearly not going to be the case going forward,” he added.

Rather, with so many institutional investors now

facing funding deficits, many are reassessing how they build their investment policies.

The conclusion increasingly is a shift to liability-led investing, with a concomitant reassessment of the expertise investment managers can bring to the table, and the role they can and should play in helping their clients meet their liabilities. As a result, managers are emerging as a more equal part of a triangular relationship alongside the institutional client and their consultant, and becoming much more connected to the client’s end goals.

“Asset managers are no longer being used just to implement policy,” says Mike O’Brien, managing director, European business channel at Barclays Global Investors. “Now we are being asked to share views and ideas and take on some of the burden of the work, and being included in the process at a much earlier stage than historically.”

But getting all parties involved in the discussion is not, by itself, sufficient. Institutions also need to make sure all the components of their investment strategy create one large, coherent picture.

“Clients have recognised there is a potential gap in the model,” says Dyson. “The individual managers can achieve their goals, but there is no guarantee that will add up to the client achieving its goal. So the mandates of the managers must all be closely connected with the end investor’s definition of success.”

However achieved, a clear issue in the industry is the separation of alpha from beta. On the one hand, firms may capture market performance through the use of passively managed products and then turn to actively managed products to generate alpha.

Increasingly then, clients are looking for the investment skill from their managers to generate alpha, and then to assemble that alpha and the right asset balance to meet their liability needs and risk tolerances.

For the investment managers, being able to generate alpha, and show they are doing so, is the ticket to higher fees.

“Clients are happy to pay for alpha,” says Anthony Finan, head of institutional marketing with BNP Paribas Asset Management. “As a portfolio manager, being able to show where you are adding value is the key element in demonstrating to clients that the money they are paying is worthwhile.”

As ever, the most fruitful relationships, and the ones with the most long-term future, are those in which everybody gains. **E**

The ETF tool kit

▶ TRADING WHOLE PORTFOLIOS

The story of ETFs is still unfolding since State Street helped launch the first product 11 years ago. *Alain Dubois* says ETFs work best for investors if looked upon as a tool.



Alain Dubois

A

s I discuss exchange-traded funds with potential investors, I am often impressed by the variety of questions that come in on the subject. A pension plan manager, a private banker and a fund manager will each have different concerns about ETFs. It is natural for there to be so many questions about this relatively new product, especially since each investor comes

with a variety of needs. And yet, in many cases, I find that their answers lie in ETFs.

Since State Street helped launch the very first ETF 11 years ago, the Standard & Poor's Depository Receipt, (SPDR) has become one of the most heavily traded stocks on the American Stock Exchange and the world's largest ETF with US\$46 billion in assets. Since that first product, the growth of the range and coverage of ETFs worldwide has been staggering. From the S&P 500 Index, to the MSCI Europe Index, from emerging markets to precious metals, ETFs now offer investors access to an extremely broad spectrum of asset classes.

Tool box

As the number, variety and coverage of ETFs have expanded, so have their uses. But ETFs are not the solution to all investor needs. Rather, they are part of an investor's tool box.

Successful investment management solutions are built to answer the needs of investors. A consultative approach that draws on the partnership between investor and manager is what leads to the creation of new products and services. It is an approach that has been vital to the development of the ETF market as we know it today.

Because they are reliable, transparent, highly liquid and cost-effective investment vehicles, exchange-traded funds have enjoyed success amid a challenging investment environment where trust has become more important than ever.

Three years ago, there were three potential groups of ETF clients: private asset managers, pension plans and other large asset managers.

The private asset managers did not want to hear about indexing. And ETFs, by definition, follow an index. This was an unattractive aspect of the product among high net worth managers, whose stock-picking abilities were a large part of their story.

Diversity

But ETFs are not, in a strict sense, index funds. Behaving like classic equities with International Securities Identifying Numbers (ISINs), real-time tradability and easy administration, ETFs fit easily into a portfolio as part of the core satellite approach. After initially seeing the ETF as an index fund, the private asset managers' perception of the vehicle is progressively changing to that of a risk management tool. The ETF, in such context, allows the manager to "tell a story" and build a diversified portfolio, at low cost.

We have all learned that portfolio diversification is essential. But for small- to mid-size private portfolios, it is nearly impossible to reach a suitable level of diversification. Consequently, the use of commingled funds for diversification is often the solution. But in some cases, clients do not want to use such funds, because of the high costs, especially if they are pursuing an active strategy.

The entry and exit fees of such funds will also negatively impact their investment performance. But with an ETF, the only entry costs will be the spread and the commissions charged by the brokers. These can be very low, allowing investors to build an efficient and diversified portfolio at low cost. For this reason, ETFs have been very popular in this segment.

Pensions

The next group consists of pension plans and other large asset managers. For these, the advantage of indexing has long been recognised. While pension plans are big users of index products, they will very rarely pay an average of 47 basis points for long-term index exposure. But in cases of sudden cash inflows, the managers need to keep their exposure to the chosen benchmark.

This is another situation where ETFs can be an answer. The manager can gain index exposure through swaps, futures, portfolio trades or ETFs. Each has its advantages. Swaps are inexpensive, but can be challenging from a legal and administrative standpoint. Futures can be illiquid or even nonexistent for a given index. A programme trade can be cost-effective, but

As sophisticated investors across the globe continue to seek broad diversification at a low cost, regions in Europe and Asia-Pacific have witnessed remarkable growth with ETFs in the past few years.

only if the size of the user is sufficient to swallow the custody and management costs.

To illustrate this point, let's say we have a pension plan with a portfolio that is benchmarked against MSCI Europe. It receives from its sponsor an inflow of €100 million to be invested across three active Europe strategies. The selection process is not over, but the allocation obliges the manager to be on the market, as close as possible from the strategic benchmark.

The manager has three options: a swap, an ETF or a portfolio trade. Because liquid futures on the MSCI Europe index are not available, the pension plan will need to perform an analysis. Since its position is supposed to last less than three months, the fees are not really an issue.

In addition, perhaps our client has some back-office constraints and does not feel comfortable initiating a portfolio trade for only three months of exposure. Also, a swap will be challenging when transition time comes and the entire position needs to be progressively sold and reinvested with new managers.

As the ETF allows exchange for physicals, which means they can be redeemed against the underlying stock, the manager can choose to take the position. This is a classic cash equitisation and a transition example.

Sectors

We have also seen situations when investors use ETFs for sector overlay or sector allocation. One of the interesting features of ETFs is that they can be shorted, either for speculative reasons, such as short selling, or as a hedging tool. Sector rotation allows an investor to make directional sector bets within a given index. And these bets can be made at differing levels of granularity, either by only using ETFs or by using a combination of ETFs and single stocks to bet within the sectors or within an index.

The overlay, on the other hand, allows an investor to protect his or her core strategic investment against sector or industry movements by hedging those sectors or industries using ETFs. The use of the product in this strategy, as well as the cost-effectiveness of such a strategy, depends largely on the size of the client and the existence of the underlying index synthetic products.

The ETF market varies widely from region to region. In Europe, for instance, the market is highly fragmented. Several ETFs coexist, sometimes tracking the same index. The important factors to understand are why and how investors are considering ETFs.

In the United States, independent financial advisors (IFAs) and hedge funds are big users of ETFs. The lower costs allow fee-based advisors to efficiently allocate assets without suffering fee drags. This is not the case in Europe because large portions of the IFA market are still based on a rebate-driven model.

The United States is still the world's biggest market for ETFs, with 150 funds holding US\$211.5 billion in assets at the end of November. But ETF assets around the world are growing at an increasingly faster rate. According to our research, there are 323 ETFs worldwide, with US\$291.2 billion in assets, of which 27.1% is managed by State Street Global Advisors.

Growth

As sophisticated investors across the globe continue to seek broad diversification at a low cost, regions in Europe and Asia-Pacific have witnessed remarkable growth with ETFs in the past few years.

In Europe, the streetTRACKS® funds are the only European ETFs benchmarked against MSCI Pan Euro and MSCI sector indices. MSCI indices are the oldest benchmarks, with 25 years of valuation data, price and return history. In addition, they target 85% of market coverage, and are built through a consistent methodology across countries, sectors and industry groups. Because they are highly replicable, liquid, and provide broad and fair market representation, the MSCI indices are the dominant benchmarks followed by institutional investors.

ETF investors in Europe also benefit from using a single provider as the sole point of contact for all ETF-related matters. Doing so allows for a smooth process in the creation and redemption of units, as well as a quick and efficient protocol for answering all questions that may arise during the product's lifecycle.

In the Asia-Pacific region, ETFs began with the November 1999 launch of the Tracker Fund of Hong Kong. Created as a way to allow the government to convert a large equity portfolio accumulated during the Asian market crisis, the Tracker Fund had a record-breaking US\$4.3 billion initial public offering, and has since grown to be among the 12 largest ETFs in the world. It has provided liquidity to the Hong Kong government and is the most broadly held collective investment fund in Asia ex-Japan.

The success of the Tracker Fund of Hong Kong inspired other markets in the region to develop similar products. There are now 35 ETFs in the region managing US\$37 billion in assets; there are also seven cross-listed ETFs in the region. New ETFs have been launched in Australia, Singapore, South Korea and Taiwan.

In China, governmental actions to reform its pension system and reduce state-ownership in Chinese corporations are setting the stage for widespread ETF acceptance. Given that more than 200 million people will retire from the workforce over the next 30 years, changes in China's lifetime pension promise are inevitable. With a tracker-type ETF, the government could assume fund shares in place of its state in state-owned firms and then exchange those shares against liabilities of state-owned firms' pension funds. This could create a whole new class of investors who might manage their pensions based on future liabilities rather than the latest trends.

The story of the ETF is still unfolding. State Street has been an integral part of its story, one that will continue to develop for large and small investors alike. ■

Alain Dubois is head of European ETF distribution at State Street Global Advisors in Brussels.

Stronger partnerships

► FACING CHALLENGES TOGETHER

Relationships between investors and managers are radically changing and becoming stronger. By *J.F. Schock*.



J.F. Schock

How is it that despite recent market, industry and regulatory changes that have placed a great deal of stress on institutional relationships, some have emerged stronger? One case in point involves the French Fonds de Reserve pour les Retraites (FRR), France's new pensions reserve fund. In a country often characterised by its adherence to tradition, the FRR has ushered in a new relationship model. In this part of the world, business relationships have historically been built to a great extent on an opaque network of personal alliances and allegiances. Once hired, a firm could confidently rely on further business from its clients. Whether or not it was the best choice for the new business really did not factor significantly into the equation. Good, bad or indifferent, old relationships still tend to linger in France and some other parts of Europe.

Change

Enter the FRR. Its launch has introduced a whole new approach to how a pension fund can be managed and served. While the old approach to business building is still alive, it is losing ground to one that is transparent and public.

Rather than relying on a single investment manager to allocate assets within the fund, the FRR hired different managers for each asset class and investment style. It also hired an overlay manager to realign asset class and currency moves to the fund's investment objectives and ensure consistency. The whole tendering process was open and available to all parties through a public web site, ensuring a level playing field.

This change from a one-party institutional relationship to a multi-party one is being driven by the industry's increasing complexity. Faced with more industry regulations and higher operating costs, pensions organisations must ensure that every aspect of their investment process is in full compliance, which often requires the work of several diligent consultants and investment managers. While administratively challenging at times, the results of a multi-party approach

are often well worth the investment, including greater overall efficiencies and better reporting capabilities.

Building relationships

Not long ago in Europe, the choices for qualified investment managers were limited to a handful of local providers who had built their franchise on long-standing relationships. Today, it is less difficult for pensions to find an assortment of potential service partners as FRR did. The real job is to find those who can consistently deliver and live up to their promises year after year.

Therefore, pensions administrators must scrutinise the potential service provider's performance track record, long-term ability to manage to predetermined benchmarks, and overall service and reliability. This is the type of open, objective process successfully used by FRR. An investment provider can have an impressive offering with all the latest technological bells and whistles, but unless the delivery strategies are clear, the relationship will ultimately be ineffective. And, having a local presence is an absolute must, especially in Europe.

Perhaps one of the most important questions a fund can ask of a potential investment manager is how the manager is equipped to take on future business. Let's say a German government pension plan begins by outsourcing its index investment strategy to an investment manager. Shortly thereafter, global custody services are needed. Within a few years, it might also want foreign exchange trading and fund accounting, daily pricing and custody services. One solution would be to pull together an assortment of specialists to meet those needs with an overlay manager, as is the case of FRR, or it could turn to a provider that could handle all the services at once in a single, integrated service model. ABP Investments, the large fund for public service workers in the Netherlands, chose the latter route, but every fund's situation is unique. If a pension fund can build a strategic, long-term relationship with a qualified manager, pension executives may actually begin to look forward to the changes the future will bring, confident in the knowledge that they are ready to meet the challenge of open and objective competition for all. **E**

J.F. Schock is regional managing director of State Street Global Advisors' investment management business in Europe, and chairman of State Street Banque in Paris.

Minding the gap

► MANAGING DEFICITS

A plethora of answers are suggested by fund managers in response to asset-liability gaps. *Paul Allen* examines them.

“When you get adverse conditions, that is when evolution kicks in. And this is an environment that encourages evolution.” So says Anthony J. Foley, managing

director at State Street Global Advisors’ Advanced Research Center.

For industry participants, the economic, financial and regulatory climate has changed profoundly. The low growth/low inflation environment means institutional investors are confronted with declining nominal yields. “Long-term bond yields have declined, spreads have tightened to historic lows and the expected return on equities has come down,” says Patrick Moonen, head of product support, mutual funds, with ING Investment Management Europe in Brussels. “Nevertheless, we see that pension plans are still based on rather optimistic long-term return projections of 6-7%.”

In this scenario, assets have been going in the opposite direction to their liabilities, creating a funding gap of epic proportions. The result is a growing interest in liability-led investing, says Mike O’Brien, managing director, European business channel with Barclays Global Investors (BGI). “You forecast cash flows and replicate those in the form of a notional fixed income portfolio, then build an investment policy against that notional portfolio. But the policy is not fixed. Rather, you constantly revise it based on movements in the funding level and so on.”

The other main areas of focus are absolute return strategies and the separation of alpha from beta. But while there is strong demand among institutional investors for alpha generation, reflected in higher performance fees, not every investment manager will be suited to that role.

But where to find alpha? Gavin Ralston, head of continental European distribution at Schroder Investment Management, points to emerging market equities and debt, and Japanese and Asia equities as potential sources, as opposed to US equities, where alpha generation traditionally is difficult to achieve. Additional sources of alpha include commodities, real estate, private equity and hedge funds.

Together with the shift towards alpha-generating strategies there is also interest in passively-managed funds, such as exchange-traded funds and indexing and enhanced indexing products, says ING’s Moonen. The result is a sort of barbell approach, he explains. “On the one hand there are passively-managed products that capture market performance, while on the other, there are actively-managed products that create considerable alpha. Institutional investors may thus adopt a core-satellite approach, with a core invested in index funds and a satellite managed by a specialist. On top of that they can add an asset allocation overlay. Tactical asset allocation will thus gain in importance as a source of alpha,” Moonen says.

Rather than tactical asset allocation (TAA), State Street’s Foley points to portable alpha overlaid on strategic asset allocation as an area gaining attention. “You can think of it like being in the same space as a conventional TAA mandate, but instead of allocating overweight France or underweight Germany, you are allocating to underlying strategies and then bringing the strategic asset allocation back using portable alpha tools,” he said.

There is then interest in structured products as a means to tailor at least some exposure to underlying liabilities. “At State Street, our PALMS product—a package of eight five-year buckets of inflation swaps—allows a plan sponsor to get inflation-indexed returns out to 40 years in a much smoother fashion than using conventional inflation-indexed securities,” Foley said.

Another area of demand is for enhanced strategies, he notes. “Enhanced indexing is one of our fastest product areas in Europe, because people have seen it is potentially a more efficient way of putting together a portfolio than the conventional style.”

Underpinning such portfolio strategies is a heightened awareness and understanding of risk among institutional investors, as they seek to better align their risk profiles to liabilities. As a result, there is a huge polarisation of positions among pension funds, says BGI’s O’Brien. “As funding levels increase, so the risk aversion increases, with funds seeking to track their liabilities more closely when they can afford to do so,” he said.

Given the widespread hit taken on equities, many institutions are looking to shift the balance of where they take risk from market exposure to a bet on their managers’ ability to generate alpha. The upshot is likely to be a desire to diversify, especially away from equity markets such as the UK’s, O’Brien says. **■**

The new paradigm

► A FRESH APPROACH

The new paradigm of institutional investment means the end of traditional benchmarking. This is good news, believes *Anthony J. Foley*, as the old practice was spurious.



Anthony J. Foley

The great 18th century Scottish philosopher David Hume, argued that one cannot get an 'ought' from an 'is'. Ethically, this is a claim that all the descriptive statements in the world do not logically entail a single prescriptive statement. The recent history of the money management industry illustrates an important corollary of this claim. No matter how

many statements are made about how money ought to be managed, they will not by themselves change how any real money is managed in practice.

This means that issues affecting investment (such as the furor about liability-led investing, the stir created by the Myners report - a major UK government-led investment review - as well as developments like new balanced management, the FRS 17 and IASB 19 accounting standards and fair valuation of liabilities) will not spontaneously generate new tools that will allow stakeholders in defined benefit plans to do things differently. A paradigm can only shift if there is a new one prodding it in the back.

In the case of strategic asset allocation for defined benefit plans, it turns out the new paradigm, like an eager understudy, has been waiting for the current approach to catch a cold for some time. This new paradigm is based on the work of Robert Merton and Paul Samuelson in the late 1960s and early 1970s. In the last few years, it has come to life as a money management tool while clever algorithms and faster computers have made implementation of these other models practicable.

The current approach certainly has caught a cold in the last few years. The average funding ratio for US pensions declined from 116% at the end of 1999 to just 75% at the end of 2002. The debate has moved on as to whether this is acceptable. As a renowned empiricist, Hume would have been comfortable with the argument that when defined benefit plans are being shut on a wide scale, it may be inferred that they are not working as well as they might.

The old paradigm has a strategic benchmark as its centrepiece. This benchmark is time-invariant and

represents the neutral position against which risk and return is measured. Given the importance of the strategic benchmark in the overall performance of any fund, a good deal of effort goes into the process of creating it. In most instances, this benchmark is reviewed periodically, often on a three- to five-year timetable.

Peer pressure

Therefore, the strategic benchmark becomes a key driver of performance. In theory, this benchmark is established by careful consideration of things such as the liabilities of the fund. But in practice, the determination of the benchmark is dominated by peer group pressure. It is otherwise hard to understand why no matter what the situation, funds in the UK are so often made up of 70% equities.

Almost without exception, the analysis that goes into establishing the strategic benchmark bears limited relation to what is done in practice by a fund. A whole industry has sprung up to bridge the gap between the strategic benchmark and the actual asset allocation of a fund. This industry takes as the starting point, the numeraire, the strategic benchmark and then measures the risk (defined as tracking error relative to this benchmark) and return (defined as excess return relative to the benchmark). One can then construct 'optimal' combinations of active managers, value and growth and all the rest of it.

Except in one special case, this is an entirely spurious practice. Risk relative to the liabilities and risk relative to the strategic benchmark are not interchangeable. Unless the strategic benchmark so happens to be the minimum risk position relative to the liabilities (if your fund has at least 70% fixed-income in the strategic benchmark you may be in this position), there is no straightforward relationship between the two kinds of risk. If a fund moves away from the strategic benchmark, it will by definition be taking risk relative to that benchmark.

However, whether risk goes up or down relative to the liabilities depends on a lot of things. Adding active management of overseas equities rather than domestic equities, adding a tactical exposure to inflation indexed securities, adding an active market-neutral portfolio can, actually reduce risk relative to liabilities, regardless of the tracking error taken with respect to the strategic benchmark. Ultimately, risk budgeting in this sense is a sham.

INNOVATION

At minimum, the new paradigm should be fast enough and flexible enough to regularly measure the risk of the actual portfolio relative to its actual and prospective liabilities.

Given the importance of establishing a strategic benchmark, it may be surprising to realise that even without the mismatch between benchmark and actual portfolio, building a fund around a static benchmark is typically not an optimal solution. An allocation which does not change through time is called a myopic allocation. In the micro-economic theory of saving and consumption, myopic solutions are only optimal under certain conditions.

Risk

This best case scenario has potential if the investors' risk appetite is independent of their wealth. There is also potential if investors are indifferent to changing risk return opportunities. In the defined benefit context, the first condition occurs when stakeholders do not or should not care about the funding ratio when making investment decisions. This is not true for very many plans. One can argue either way for changing risk return opportunities, but not for both at once.

In discussions about new approaches, people will sometimes argue vehemently that risk premia cannot be forecast, then argue just as strongly against cutting equity allocations when funding ratios fall because of mean reversion in equity returns. This is where the distinction between an 'ought' and an 'is' comes into play. The aim is not to say what preferences stakeholders ought to have. The aim is to allow those preferences to be appropriately expressed in the portfolio.

Many people seem to have become confused on this point. Putting liabilities centre stage does not mean investing 100% in fixed-income. Measuring risk relative to liabilities does not tell you anything about how much risk one ought to take relative to those liabilities. Measuring risk relative to liabilities is not the same as matching risk relative to liabilities.

The new paradigm should also handle preferences for a risk appetite that depends on the funding ratio. It should also be able to handle investors who believe there is mean-reversion or other structure in long-term returns.

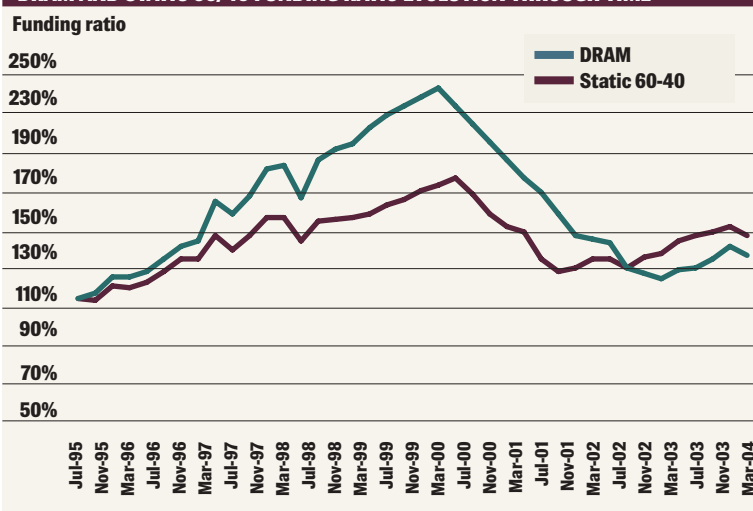
Recently, State Street Global Advisors introduced the Dynamic Risk Allocation Model (DRAM) which is based firmly on the Merton approach, adapted for defined benefit plans. It meets the requirements of the new paradigm. Equally important, when money is managed using DRAM, it can become possible to get to the 'is' from the 'ought'.

By working with a fund's actuary to build up a picture of the fund's liabilities and then working with the fund to get a sense of the trade-off between funding ratio and risk aversion and building from there, the current best practice model is replaced by an integrative framework that ensures all of the key decisions on the fund's allocation and active exposures are made with the fund's liabilities as the numeraire.

Results

To illustrate, a simulation was run using US data from January 1995 to October 2004. In this case, it was assumed a fund became more risk averse at very low funding ratio levels while at very high funding ratio levels risk

DRAM AND STATIC 60/40 FUNDING RATIO EVOLUTION THROUGH TIME



aversion and expected returns were held constant. The assumed equity risk premium over cash was 5%. Liabilities were assumed to depend on both inflation and interest rates. On this basis, the estimated annualised funding ratio volatility using DRAM was around 14%. This is significantly lower than most real life US plans and compares with a calculated funding ratio volatility over the same dataset using the conventional US 60/40 allocation of 22%.

The DRAM simulation also delivered better overall performance with an ending funding ratio that was 10% ahead of the static benchmark. The path taken by the funding ratios in the DRAM case and the 60/40 case are illustrated in the chart above.

Of course, the actual results over the future and in a simulation depend on multiple factors. However, since it is impossible to manage risk without measuring it, this new paradigm gives stakeholders the opportunity to change over to a more rational approach to defined benefit management.

The simulation pictured here is essentially equivalent to running an asset liability model exercise once a quarter; each quarter took about 10 minutes to run. This is an order of magnitude faster than a conventional asset liability management exercise and means that DRAM also meets the first requirement for the new paradigm: It is flexible enough to do away with the need for a dubious two-stage risk budgeting process.

In a final nod to Hume, a classic quote is that "custom then is the great guide to human life". It is clear that the environment has changed in the defined benefit world and with the introduction of more market-based accounting for asset values and potentially fair valuation of liabilities will change more. In this new world, what is customary will no longer work.

With marking to market, the measured volatility of a defined benefit plan using the current approach is too high and the cost of providing a liability matching solution is likewise extremely high. DRAM and similar products are moving the debate from 'ought' to 'is' just in time. **E**

Anthony J. Foley is managing director of State Street Global Advisors' Advanced Research Center.

Reinspired by bonds

► FIXATING INCOME

After a long time running in second place to equities, bonds are fast emerging as an essential asset class for European institutional asset managers. *By Joseph Moody.*



Joseph Moody

It has been a long time coming for bonds. In the 1970s, rampant inflation made them a disastrous investment. The 1980s saw their reputation further damaged when financiers used high-yield bonds as weapons in many hostile takeovers. That period gave us the term junk bonds. Then during the 1990s, bonds were completely overshadowed by equities and for obvious reasons. Only since 2000, with the extended decline in the equity markets, has the asset class been held in higher esteem.

Today we're seeing a renewed interest in bonds, especially among institutional investors. And it's not just sinking equity returns that are driving the resurgence. New regulations for European pension funds have also forced them to consider investing more of their assets in fixed-income securities.

These new regulations in European countries including the UK, Holland and Denmark are focusing on the solvency of pension funds and their investment risks. Starting 1 January, UK companies will have to list the equity risk of their pension funds as a balance sheet liability.

Companies with pension plans aren't the only institutional investors who have to respond to the new regulations. A variation of new capital-accounting regulations is on the way for insurers as well.

The downward plunge in the equity markets at the beginning of the century was especially hard on pension funds. Many companies took a holiday from contributing to their pension plans during the precipitous days of the stock market, because the high returns on their equity investments more than made up the difference. And when the stock markets and the economy headed earthward, many of those companies found themselves unable to increase their pension plan contributions to the degree necessary to make up for the growing shortfall in those pension funds.

The hard-learned lessons of the bear market and the resulting regulations mean that institutional investors' asset allocations will begin to move toward much heavier bond components. The equity-to-fixed-

income ratio for pension funds in Holland has historically ranged from 50/50 to 60/40. In the UK, the ratio has historically been more aggressive, with some maturing funds running at 80% equity, 20% fixed-income allocations.

The shift toward a heavier fixed-income weighting in institutional portfolios won't be a short-term change either. The trend is likely to last for several years.

As they move more assets back to fixed-income investments, institutional investors are looking for solutions that satisfy their goals of producing a healthy return as well as keeping their on-book pension liabilities low.

One asset category that has seen a lot of activity from institutional managers as a result of the new rule is inflation-protected bonds. While they are perceived to offer less yield than other bond issues, they are a way of keeping liabilities low. Many plan sponsors have complained that, in the short term, a portfolio with a heavy weighting in inflation-protected bonds will require a higher contribution level from them. But that short-term cost is far more manageable than the kind of portfolio meltdowns that have been occasioned by more aggressive and risky allocations.

Nevertheless, many institutional managers quickly realised that simply investing in conventional or index-linked fixed-income instruments was not necessarily the low-risk solution they thought it would be. Because neither a portfolio containing conventional government bonds, nor inflation-linked bonds can provide a cash flow matching return to the desired liability profile of these investors, so we looked to the swaps market to provide the solution. Interest rate swaps can be created for every maturity profile required – with or without an inflation hedge.

A solution to ensure that the pension fund's projected liabilities, which include continuing disbursements to pension-plan participants, are paid as they fall due, is a viable solution. The goal of this new approach is to offer pension plans the ability to match their portfolios more closely with their projected future liabilities in a flexible, efficient, and cost-effective way, which cannot be achieved using conventional or index-linked bonds.

Many institutional managers quickly realised that simply investing in conventional or index-linked fixed-income instruments was not necessarily the low-risk solution they thought it would be.

It can be done by using zero-coupon inflation-linked swaps that pay out on an annual basis and allow tailored allocations to different liability profiles. Constructing a portfolio of swaps significantly reduces the mismatch risk, regardless of the inflation scenario. Using swaps, the pension fund can lock in today's real rate, secure its fixed rate, and also hedge against adverse future inflation. This method should allow the fund to meet its future pension obligations with a high degree of certainty.

The market is ripe for this approach. Today, there is continued growth and acceptance in the use of complex derivatives to create innovative solutions in more accessible vehicles. The developing use of derivatives has allowed the separation of conventional bond components into products in their own right. Interest rate futures, diversified credit overlays and inflation swaps have all been created as part of a movement to better serve investors needs.

An example is the depth and breadth of the US credit market, which continues to serve as model for the European and Asian markets. In Europe, the market has evolved to the point where credit default swaps are not just the domain of hedge funds and investment banks. In that respect, Europe is now on a par with the US.

At the same time, European inflation-linked products are growing rapidly as both institutional investors and governments recognise their long-term value. Germany is planning to follow France next year to

issue new inflation-linked bonds. Italy and Greece have already issued such bonds as well. Overseas, Japan is also working on its own inflation products.

While its inflation-linked products continue to expand, the European inflation swaps market is more advanced in many ways than the US Treasury inflation-protected securities market. The participation of both retail and institutional investors has helped to construct a sophisticated and substantial inflation swaps market. Although smaller, the UK regularly trades out to 40 years and public/private finance partnerships have been a catalyst to developing market liquidity.

Generally, we observe that the approach to fixed income is becoming more global, with global firms taking advantage of their local expertise and product knowledge in several different time zones to greater effect.

And as the institutional fixed-income markets and the needs of institutional and some retail investors become more sophisticated, a number of new instruments are coming into high demand. Some of these asset classes, such as credit default swaps, are difficult for institutional investors to access without the assistance of investment bankers. As a result, they are seeking out larger, more broadly capable brokerage houses to act as intermediaries in the fixed-income world.

This need for more derivative and off-the-beaten-track issues, along with the increasingly transparent and decreasingly profitable bond trading business has made life difficult for small and mid-sized brokerages in the fixed-income area. On the buy side, smaller investment firms are outsourcing in recognition that the investment in complex risk management and processing systems are too onerous for them to remain committed players. Larger brokerage houses are needed to access and coordinate the complex securities and strategies in an efficient and cost-effective manner. **E**

Joseph Moody is vice president of State Street Global Advisors in London.

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Pressure release

► COSTS AND FEES

Paul Allen looks at how fund managers are responding to pressures to generate revenues and control costs.

Efficiency may be a perennial theme in the industry, yet at times it receives more lip service than real action. But with forecasters predicting modest market returns for the foreseeable future, investment managers can ill-afford to neglect the strong efficiency wind blowing through the industry.

The two main areas of efficiency focus on revenue generation, which includes looking at product trends and fees associated with those products, and cost management, in which the overarching theme is of centralisation, says Robert Parker, deputy chairman of Credit Suisse Asset Management.

On the revenue side, the two clear trends are towards total or absolute return investing, away from benchmark investing, and the issue of “investor bar-belling”, in which investors shift from traditional mid-risk products towards the low and high ends of the risk spectrum, says Parker.

As Nigel Wightman, a principal and managing director at State Street Global Advisors, observes: “On the one hand clients are looking for lower risk products, be it the switch from equities to fixed income, from transactional active to low-risk active or passive, and the move towards more liability-matching investment solutions. Then there is a move, to some extent offsetting that, towards high alpha products, whether very active traditional long investments, hedge funds, private equity or whatever, which will continue to provide some relief to fund managers.”

A number of themes emerge then for asset managers. If they stick to a business model of traditional, relative return, large-cap equities they will experience weakening demand, Parker says. Meanwhile, at the lower end of the risk spectrum there is a trend towards departing from indexed business into enhanced indexation, on the thesis that the pure index business is being somewhat replicated by people buying futures, or exchange-traded funds.

At the higher end of the risk spectrum there is a big shift in capital flows into those various asset classes, including emerging equities, real estate and private equity, says Parker. In addition, there is big demand for much more sophisticated, risk-based asset allocation skills.

So with fees going down in traditional core business, asset managers have had to refocus on new client

demand as a means to maintain or grow their revenue. The key criteria then will be whether an asset manager can generate alpha for the client. The underperformers who have trouble beating their benchmarks have a couple of choices, says Peter Schwicht, head of European institutional business at JPMorgan Fleming Asset Management. “Either they go for very low fees, or really concentrate on what they can do and de-emphasise those areas where they cannot generate the extra alpha, and then look at sub-advisory,” he says.

For medium-sized portfolio managers in particular, sub-advisory is one way to generate efficiencies on the product side, says Schwicht. “For example, if you have a global mandate, you can leave Asia, which is quite expensive to produce, to a third party.” By sub-advising parts of the mandates, thereby becoming more of a compiler and not so much a producer, the manager still makes sure the bundled product that is given to the client is generating some decent performance, Schwicht added.

Outsourcing the manufacture of investment returns, in whole or in part, is therefore a potential theme for the industry, as firms focus on core activities. “You will get a clear distinction between managers that are essentially manufacturing investment returns, which is what we are, those that manufacture returns and have a significant distribution arm, such as Fidelity, and those that are in the distribution business but don’t need to be manufacturing significant pieces of the investment return,” says State Street’s Wightman.

Ultimately, it is a question of scale. Trying to manage money in multiple locations, and delivering a variety of investment products through a number of channels brings with it corresponding efficiency challenges.

One impact is a growing interest in structures that allow managers to commingle assets. “Big fund managers are continuing to work on new and improved ways of taking lots of segregated business and putting them into cross-border pools, in order to gain scale and efficiency for the fund manager, which allows them to reduce their price to the underlying client,” says Wightman.

Cost efficiency then is all about centralisation: slimlining products to get a greater concentration of assets, centralising asset management where possible, centralising marketing and centralising back-office functions to reduce the number of different administrative centres and IT platforms. The degree of success firms have in centralising their businesses will be the true differentiator among providers. At least for the time being. **E**

European pensions hedge their bets

► FACING NEW CHALLENGES

It is a myth that hedge funds pose excessive risk in pursuit of above-market returns. And they offer almost as much variety as equity mutual funds, say *Paul Duncombe* and *Erich Stock*.



Paul Duncombe

For a couple of decades, hedge funds — like derivatives — were labeled as dangerous, speculative and unregulated investments that posed high risk. But that perception is changing fast. In 2004, Europe's institutional investors have started considering hedge funds on an unprecedented scale. And the interest is expected to become even more pervasive during the rest of the decade.

Just five years ago, many European pension schemes typically invested none of their assets in hedge funds. Today, an increasing number of companies from the United Kingdom to Sweden are testing alternatives, reallocating assets from traditionally conservative holdings and into some of the 6,000 hedge funds available to them, mainly through fund of fund vehicles.

Changing demographics

While not new to the European landscape, hedge funds have been largely used by just a handful of sophisticated institutional investors and private bankers on behalf of wealthy clients who were ahead of their time in recognising hedge funds as a tool for managing risk. It's not unusual for some high-net-worth individuals to invest up to half their portfolio in hedge funds. But those are the exceptions. Similar to the United States where hedge funds have only about a 1.3% allocation from pension funds (but significantly higher levels from endowments and foundations), Europe's institutional investors, with just 1% invested, are also just beginning to explore the potential benefits. Understandably, institutional investors and governments are approaching the prospect of widespread hedge fund investing with a mixed sense of optimism and caution. They are following the lead of

those retail investors who became disenchanted with poor equity performance during the bear market.

The trend toward alternative products reflects a dramatic departure from Europe's conservative investment culture, which has been centered on a steady diet of government bonds and cash vehicles. As recently as 10 years ago, such investments were adequate enough, generating relatively high returns with low risk. But more recently, Europe's once-reliable fixed-income markets have hit a difficult patch at the same time that an aging population has forced many governments to reconfigure state-run retirement systems to ward off bankruptcy. Nations like Germany and Italy, which used to reward retirees with up to €8 for every €10 of their final salary, will, in the not too distant future, only pay €4-5 for every €10 earned.

In the mid-1990s, when company pension funds began experiencing earnings shortfalls, trustees ventured into the equity markets with some degree of success. Of course, when the high-tech bubble burst, European pension funds, like their US counterparts, suffered. The 2000-03 bear market left serious funding gaps for pension plans across Europe, particularly those with inadequate diversification. Trustees had little choice but to explore new ways to bolster portfolio performance. With their low correlation to equity and bond market performance, hedge funds became a clear alternative option.

Demystifying hedge fund risk

The next several years will present a steep learning curve for investors and professional managers alike. The first myth to be debunked is that hedge funds pose excessive risk in pursuit of above-market returns. In fact, hedge funds offer almost as much variety as equity mutual funds, with strongly uncorrelated styles, and are typically used as a way to mitigate losses.

Rather than perceiving hedge funds as a separate asset class, investors should view them as an invest-



Erich Stock

TOP EUROPEAN EQUITY FUND FAMILIES

Fund group	Funds rated	Average
Storebrand	35	3.37
LCF Rothschild	39	3.31
State Street	42	3.26
Robur	40	3.25
Barclays	45	3.24
Minimum 30 ratings needed to qualify		
These tables are based on Morningstar Ratings for August.		

ment style or approach that can invest across asset classes. The distinction that sets hedge funds apart from traditional mutual funds is the pursuit of absolute returns. Whereas an equity mutual fund manager typically structures his or her portfolio to beat some market index or industry benchmark — this is known as relative-performance investing — a hedge fund manager will create a portfolio of securities to beat a specific dollar or percentage return target. Whereas the former focuses on active risk (i.e. risk relative to a benchmark), the latter focuses on total risk (i.e. the hedge fund manager's objective is to avoid absolute financial losses).

There are advantages and disadvantages to both approaches. On one hand, an absolute-return style may underperform a relative-performance style during periods of low volatility like this year or when stocks are in strong bull markets such as during the late 1990s. On the other hand, an absolute-return strategy can help lessen the negative impact of a volatile stock market by reducing a portfolio's downside risk. There is a wide range of hedge fund strategies, each with distinct risk-return characteristics.

At the simplest level, hedge fund strategies can be broken down into two categories: arbitrage and macro or directional strategies. Arbitrage strategies are designed to deliver 'reasonable' returns with relatively low risk by exploiting price discrepancies between closely related securities. With names such as convertible, merger arbitrage or equity market neutral, these strategies tend to deliver steady returns in most market conditions. However, it is possible to experience precipitous drops in value during unusual events such as a sudden financial crisis.

To offset the risks associated with an arbitrage-based strategy, it may be prudent to add a macro-based element within the same portfolio. This may include such approaches as global long/short positioning, futures-based, and currency-related, which seek to exploit valuation movements in or among select asset classes or markets based on the manager's assessment of, say, a country's economic outlook. Managers often use sophisticated technical models to assist in timing. Compared to an arbitrage model, a macro-based model offers the potential to deliver higher returns in exchange for accepting greater risk. This strategy tends to perform best when market trends are strong.

Creating a portfolio with a balance between arbitrage and macro-based strategies is not easy, particularly when it involves several managers within a single style. At this point in time, because the number of arbitrage opportunities is limited, most managers will be holding similar positions. That means if something goes wrong in one position — let's

say, some central bank makes an unexpected interest rate shift or a merger deal fails — all of the managers within that area could suffer. On a positive note, as more arbitrage opportunities develop in the future, such potential concentrations of risk should diminish and work to the advantage of investors.

Flexible strategies

While hedge funds generally have a low correlation to traditional asset classes, each strategy poses a degree of risk. Diversification within a hedge fund portfolio is critical as a risk-control measure. Hedge fund-of-fund managers seek to combine the right blend of styles to pursue a predetermined risk-return objective for clients. Here are three broad hedge fund styles investors should be familiar with:

- Relative value poses the lowest net market exposure and includes management strategies with names like convertible arbitrage, fixed-income arbitrage, and equity-market neutral.
- Event driven poses medium-market exposure and includes management strategies that involve risk arbitrage and distressed securities.
- Opportunistic poses the highest exposure to the market — and highest potential returns — through global macro, short-selling, and long/short equity strategies.

It is said that for hedge funds to contribute meaningful returns to an institutional portfolio, a minimum allocation of around 10% may be needed to have a beneficial impact over the long term. Allocations of less than 5% may be insignificant in terms of overall impact.

Growing pains

Strategy risk is not the only challenge investors must consider. There are also risks associated with the skill and expertise of individual managers as well as risks that arise from inadequate operational support in small-sized companies. Prior to committing money to a fund or funds, it is imperative for investors to undertake full due diligence to understand the underlying trading nuances of different management styles and, in particular, their operational infrastructure as well as the credentials of fund managers. The ultimate question for an investor is: how will the introduction of an additional strategy or management style influence the performance potential of my existing portfolio?

Hedge fund-of-fund managers can serve their institutional clients well by implementing a broad spectrum of styles to enhance diversification while at the same time providing the necessary risk monitoring. Although a single-strategy hedge fund may be appropriate for certain individuals with precise risk and return goals, institutional investors can gain instant diversification through hedge fund-of-funds that mesh a variety of strategies.

An investor's concerns do not end following a purchase. Because hedge funds are actively managed, the correlation between strategies tends to change over time. Investors must monitor their portfolios regularly to ensure that they maintain a minimum level of diversification while pursuing stated goals. If executed properly, a balanced hedge fund portfolio can help investors attain a level of performance stability that

The proliferation of hedge funds throughout Europe will require more government reforms and cross-border cooperation.

might not be otherwise possible through stock and bond investments alone. The growing acceptance of hedge funds in Europe is also likely to open up new business opportunities and revenue sources for investment firms.

Europe's institutional investors are likely to further contribute to the nearly US\$1 trillion worldwide hedge fund marketplace. The shift is likely to occur gradually as governments revise restrictive regulations to make hedge funds more accessible to both retail and institutional investors. Though still a relatively young industry, some hedge funds have a solid 10-15 year investment history behind them with track records of generating absolute returns consistently in diverse economic cycles. Those are powerful selling points.

The European challenge

Because Europe comprises several markets with each harboring its own unique perspectives and biases about hedge funds, implementation may be uneven at first. Countries like Italy and Switzerland already allow — with some restrictions — residents to buy hedge funds onshore. Despite strict tax transparency and other conditions imposed on hedge funds, Germany's new regulatory framework allows retail investors, under

certain circumstances, to buy approved hedge funds and fund-of-funds within its borders, which was much more difficult before 2004. The proliferation of hedge funds throughout Europe will require more government reforms and cross-border cooperation for greater continuity and consumer safeguards. For investment professionals who hope to reap the rewards of a burgeoning hedge fund marketplace, understanding the rules of the game and keeping abreast of legislative revisions is a necessary evil.

As more institutional investors gain experience with multiple strategies, they are likely to start investing directly in single hedge funds in conjunction with, or instead of, hedge fund-of-funds. Similarly, hedge fund managers who had previously embraced a single hedge fund vehicle or strategy are likely to add additional funds and strategies to a shared in-house platform. Managing five or even 10 hedge fund strategies within a single hedge fund company has already led to the offer of multi-strategy funds, which allocate to the various hedge funds managed in-house. Even if less diversified, multi-strategy funds may potentially offer a more cost-effective alternative to hedge fund-of-funds by avoiding a double layer of fees.

If you are a proponent of active investment management, then hedge funds - the purest form of active management - are likely to play some role in your future. **E**

Paul Duncombe is deputy managing director of alternative investments for State Street Global Advisors. Erich Stock is in charge of State Street's hedge fund business development in Europe and Asia.

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The secrets of quant fund success

► AVOIDING INFORMATION OVERLOAD

Top performing fund managers have made the choice to spend capital on information technology and the people to support it. That's the 'secret' behind quant investing, explains *Susanne Willumsen*.



Susanne Willumsen

Quantitative managers are increasingly found in the top quintile of the European fund performance tables. This is particularly true of tables showing risk-adjusted returns, or information ratios, which measure the return generated per unit of risk. By this measure, quantitative investment managers far outperform most other managers, as few traditional managers can consistently make the same claim over multiple performance periods.

To be sure, this outstanding performance has not gone unnoticed. Most investment consultants highly recommend quantitative managers to their pension fund clients, and funds available to smaller investors are also seeing net inflows. The resulting unprecedented flow of assets into quantitative strategies has caused the majority of quantitative asset managers to close or consider closing strategies to further investments.

But why have quantitative investors been so successful? To begin to understand the reasons, let's first highlight the main differences between quant managers and more traditional managers.

Information overload

With the advent of the technology boom and the internet, information is everywhere. Fund managers are constantly bombarded with potential market-moving news. Company news is delivered via broadcast, print and online media, and sometimes directly from the company. A fund manager must assemble all this information and decide whether or not the new infor-

mation may affect a company's share price and, if so, which direction the share price will move. The manager must also consider news that affects the economy or a particular company's sector, including potential litigation and geopolitical events.

This amount of information is truly overwhelming. To help fund managers sort through it, the fund management community has embraced technology. In the past, traditional managers may have had access to company insights on key pieces of information affecting the firm's stock price. Today this level of information is available instantly over computer networks. In fact, companies that make selective information available only to key analysts are penalised severely. As a result of this situation, all fund managers—whether traditional or quant—have embraced advances in modern technology that help them process the vast amounts of information they receive. The main distinction between these two types of managers is the extent to which their firms have taken technology on board.

Many institutional investors use quantitative tools, such as screens, to limit the amount of information they must process. However, these are generally not the managers you see at the top of the performance tables today. The managers at the top share at least one thing in common. They have made the distinct choice to spend capital on information technology and the people to support it, as opposed to hiring more people and investing in quantitative tools to assist them. This distinction is paramount.

Technology steps in

Running a truly quantitative firm is commonly thought to be a cheap way to enter the money management market. This is a big misconception. Many companies have gone halfway to quant and have not succeeded. The cost of acquiring the data necessary to drive a robust investment process and hiring the peo-

ple to maintain and run the technology going forward is in fact not much different from staffing up a traditional investment firm. Further, company management must fully accept that technology is better equipped than the human mind to cope with vast amounts of information. Of course it is true that, so far, a computer is not capable of generating new ideas on its own. For that, firms must invest in the people and the resources to help drive the process.

And this is exactly what successful quantitative firms have done. They have fully embraced technology and research to help their fund managers avoid the dangers of information overload, such as an overreaction to news that is of no importance or an under-reaction to important news. They also realise that technology can help remove fund managers' cognitive biases – a fancy term for people doing the wrong thing based on past experiences.

Quantitative managers know human behaviours are flawed. They accept that the quantitative process forces them to act in a way that may conflict with their instincts. This happens systematically, and that is one of the most important reasons why quantitative managers perform so well. When traditional managers are presented with the same information as quantitative managers, they cannot process it in a systematic fashion.

That's because the human mind is emotional, while a systematic quant process is not. A quantitative process will force the manager to sell or buy a stock, day in and day out. Of course, the process will occasionally choose the wrong time to buy or sell, but even a 55% success rate can lead to table-topping performance.

A question of capacity

How many times have we seen enormously successful traditional managers boasting a fantastic track record gather assets at unprecedented speed only to lose those assets at the same pace a few years later? Without naming names, we all recognise this familiar scenario. It is a phenomenon driven by the herd instinct that consultants and investors exhibit when allocating assets. That instinct is governed by a fear of missing what appears to be a free lunch.

Of course, it is not really a free lunch. After all, asset managers are in the business of growing assets and increasing the average fee charged for managing those assets. This is the case both for quantitative managers and traditional managers. However, quantitative managers have a distinct advantage in that they can recognise, and are motivated to act on, capacity constraints. This is because the classic quantitative strategy is based on a portfolio of diversified securities with measured predictive powers, portfolio characteristics, and trading impact. As a result, the inherent chipping away of risk-adjusted performance associated with a growing asset base is easily observed. In this respect, quantitative managers are very similar to hedge funds, which routinely close to new investments once they have reached a certain size.

Yet, why do we not often see traditional fund managers closing funds? While greed surely plays a role, these firms also greatly underestimate the rising level of risk that comes with investment success. Because they invest in people rather than technology, tradi-

tional managers do not fully appreciate the problems inherent in escalating a successful investment strategy with a low asset base into a large scale operation with each individual holding carrying a substantial liquidity risk.

For instance, it is not unusual for a traditional investment manager to hold up to 10% or more of the outstanding capital of any single company. While the investment theses that caused them to invest in the company may be correct, the holding carries an unprecedented stock-specific risk making it vulnerable to company-specific events. Current examples include insurance companies being investigated in the US and cases of accounting irregularities at European companies such as Parmalat and Ahold. Whereas quantitative fund managers may have been invested in any one of these names, their stake would have been manageable enough to get out without demanding a huge liquidity premium for doing so. In fact, it is often difficult to spot quantitative investors among the registered holders of European shares. This is because their portfolios are typically very liquid and their holding periods are limited.

In fact, quantitative strategies lend themselves to determining capacity limits and the level at which the strategy should close. Through the privilege of technology and data availability, quantitative managers can estimate the loss of information ratios related to a growing asset base. They can run historical simulations that can accurately forecast the loss in returns and the additional liquidity risk they would need to accept to be a credible player. This is indeed one of the reasons why quantitative managers have and should continue to have a real performance advantage over their more traditional counterparts.

Where do quant managers go from here?

As long as quantitative managers do not become complacent, greedy, or disseminate their technological advantage to the marketplace too broadly, this alternative investment niche remains in great shape to service an increasingly demanding customer base. But, quantitative firms must also continue to innovate new technologies that help them become stronger, better and faster. The most financially rewarding avenue of technological advance is surely natural language processing.

In the past, quantitative processes have been unable to deal with the written word. Although it has been possible to interpret simple text strings with quantitative tools, technology is now available to interpret and quantify analyst reports and verbal broadcasting in numerous languages. This is the focus of serious quantitative managers today. Yet, it demands an enormous upfront investment in technology and people. And, while a successful solution will not emerge fully until the medium to long term, quantitative firms that are serious about their philosophy and their clients' investment returns cannot sit on the fence. They must make the financial commitment in technology and people to ensure the future of their strategy. **E**

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