

Special Report

**Low Return Environment And
The Search for Alpha****Analysts**

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■ Summary

The MSCI World Index rose 150% during the 1990s, providing comfortable asset returns for investors. Pension funds were largely funded and insurance companies were offering attractive rates of return. The collapse of equity markets around the world at the start of the Millennium brought investors back down to earth. In the space of two years, four years of stock market growth was wiped out. The situation was all the more difficult as most investors, institutional and private, had increased their equity exposure in the late 1990s. With a 31% return (performance of the MSCI World Index in USD terms), 2003 appeared to many to have been the year of recovery. However, past performance has revealed three distinct market trends: bull, bear and flat (e.g. as in 2004). Against the backdrop of the long-term returns and the current level of asset valuations, ever more financial professionals are coming to believe that asset performances could be very disappointing over the mid-term. What would the impact be for institutional investors in the event the prophecy becomes reality?

Firstly, in light of their risk aversion vis-à-vis asset returns and the capacity of fund managers to increase value, institutional investors will have to reconsider outsourcing management of their assets. With single-digit asset returns, it is quite possible that they will increasingly match their assets with their liabilities. Stringent asset-liability management, cash flow matching or portfolio insurance techniques will undoubtedly gain further momentum among institutional investors. Additionally, they will be reviewing their allocations to actively managed strategies which seek to achieve alpha returns, reconsidering their mix allocations between passive and active. While many have been disappointed if not left feeling let down by the traditional “benchmarked” active managers, no doubt significant funds will be redirected into passive management on one side and highly active management on the other.

Secondly, investors will have to employ greater energies to realise alpha. When returns are 10% p.a., the quest for alpha is reduced, whereas 50bps of outperformance becomes a substantial incentive when asset returns are closer to 5%. Hence, in the current return environment, the search for investment managers able to generate alpha implies a greater focus on individual evaluations to determine whether they have the appropriate investment framework, agile investment processes, experienced and skilled personnel, and a genuine capacity to find added value in financial markets through heightened research, specialisation, and depth of asset-specific analysis.

Toward a Low Return Environment

In many countries, the asset management industry experienced significant growth and expansion in last two decades of the 20th century, generally in parallel with financial deregulation, the development of pension fund systems and sustained savings rates. Despite some market volatility, this period remained benign. Table 1 shows the real return in USD terms of both stocks and bonds over various periods. From 1981 to 1999, stocks generated returns of 13.6% above inflation and bonds 8.4%. A 50-50 passive mix would have produced a double-digit real return. For investors and pension funds, such 'long-term' returns were well in line with their investment objectives (retirement, threshold returns of life insurance companies or foundations, etc). No one had foreseen the collapse of stock markets around the world at the start of the new Millennium (the MSCI World Index fell 42% between end-1999 and end-2002 in USD terms). The turbulence wiped out pension surpluses, insurance companies' balance sheets and the double-digit returns most asset managers had achieved for investors. Longing to achieve past returns, many investors increased their exposure to riskier assets and asset managers focused on attracting new money chasing such investments. With 2003 marking a return to stock market growth, have concerns been eased? That remains to be seen.

Indeed, table 1 also shows that, despite slumping equity markets, the real return since the early 1980s is still 2% above the post-war, long-term average of 6.9%. Past experience and fears that equities may still be overvalued are making many financial professionals cautious about the next decade. Moreover, with historically-low yields on government bonds and credit spreads, the other asset classes may also become the victims of "low return" syndrome.

Table 1: Investment Real Returns (Rebased to USD)

Periods (%)	Stock Real Return	Bond Real Return
1946-2003	6.9	1.5
1966-1981	-0.4	-4.2
1981-1999	13.6	8.4
1983-2003	8.8	7.7

Source: Siegel [2004]

Therefore, a scenario of continuing single-digit returns on traditional investments has many investors, most notably, pension funds, insurers, foundations and endowments favouring products offering the promise of greater returns (hedge funds, high yield, etc.). However, which investors will participate in the active search for alpha will of course depend on

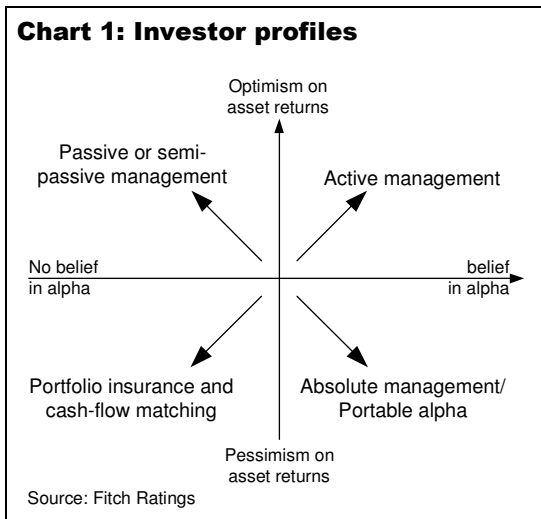
whether they believe alpha generating strategies and managers who can effectively execute such strategies can be identified.

Strategic Choices for Investors

Many pension funds and insurance companies face huge challenges. For some, the situation is already tough, with substantial underfunding. Underfunding estimates vary from one source to another, but most figures are between USD50bn to USD200bn in the US or the UK. Beyond the current deficiency in funding, actuarial dynamics are driving the need for a re-evaluation of investment strategies and asset allocation decisions. While life expectancy continues to increase, to preserve pension levels, whatever the system, either one has to save more or the capitalisation rate has to be higher, or both. Life insurance companies face a similar problem: they need 5% to 6% gross returns to meet their commercial promises, but yields on government bonds are currently falling far short of these requirements.

These and other institutional investors are increasingly aware that they face strategic investment decisions involving asset allocation and manager selection issues to a far greater extent than in the recent past. As no one knows with any degree of certainty whether equity returns will be 6% or 12% over the mid-term horizon, the primary element of strategy formulation will rest on defining a new risk/return paradigm incorporating an investor-specific re-assessment of their risk tolerance. The degree to which such a shift may be acceptable will of course depend on each investor's level of risk aversion and view of the markets.

How investors view two essential questions will determine, to a great extent, their profile for coping with the current low return environment. The first question is whether or not they believe investment managers can garner alpha. The second is what is their level of optimism regarding traditional investment returns over the short-, mid- and long-term horizons. The investor who does not have any faith in alpha generation is convinced that, on average, portfolio managers cannot add value above market returns. Then there is the pessimist who believes that markets could slump further over the next 10 or 20 years and there could be a return to the negative real returns of the "inflation era" of the 60s and 70s (see Table 1). These two opinions are independent of each other as one can believe in alpha and vice versa. Limiting ourselves to the two dimensions of views on alpha and expected returns on traditional investments, four hypothetical investor profiles emerge, as is shown in Chart 1.



Once the investor psychology has been clarified, the right investment strategy can be identified. If an investor had asked both questions some 10 years ago, market participants would have been puzzled, not only because the assumptions would have appeared bizarre but also because, essentially traditional active management was available. The recent bear market has forced investors to actively search for alternatives, and the industry has obliged by developing or expanding investment product offerings to include structured products, actively managed and alternative investments.

The most pessimistic investor does not believe in alpha and is bearish about asset returns. For such an investor and when risk aversion is extreme, cash flow matching and capital preservation becomes the primary objective. Risky assets can be invested with portfolio insurance techniques using CPPI¹ or options offering protection against drawdown and losses.

The second category of investors consists of those disappointed or left feeling let down by their asset manager but still optimistic about the secular economic trend in general and the financial markets in particular. However, for them, alpha will always be a chimera, as financial markets remain a zero-sum game and passive management appears the right solution. It is no surprise that this segment of the asset management industry has gained the lion's share of net sales over the last few years and passive

managers now rank highly in terms of assets under management. For those who still believe in alpha somewhat, the solution also lies in indexed-enhanced management such as those based on quantitative modelling. Beyond the degree of active management tolerated, the ultimate investment decision for such investors will revolve around asset allocation, which will be deemed to account for the bulk of the returns achieved.

The third category of investors does believe in alpha but is pessimistic about asset returns. What they need is risk-free alpha (absolute management using hedge fund techniques) or alpha above a liability-led reference (portable alpha concept²).

The last group of investors is the one asset managers are accustomed to dealing with. Confident in both asset returns and fund managers' capacity to generate alpha, they seek "traditional" active management. However, recent years have made such investors far more demanding and more prone to abandoning an asset manager if performance falls short of expectations. Not surprisingly, the right product for such investors is the "alpha-generating portfolio"³. As for the second category of investors, asset allocation will be crucial, even if, in this case, alpha may partially offset a poor performance within the asset mix relative to the liabilities.

Obviously, investors can position themselves on multiple points on Chart 1, using several investment management products simultaneously, as is demonstrated by the development of the core-satellite approach. This technique consists of splitting a portfolio between "core" managers tracking market indices (passive and semi-passive) and very active managers. Portable alpha can also be used on top of a passive portfolio whose cash flows are matched to liabilities. Naturally, there are many other potential blended configurations.

Since the current low return environment has forced many investors to reconsider the way they delegate management of their assets, they have increased their focus on re-evaluating their investment strategies and decision-making processes. This is most notable in their greater use of resources and third-party advisors specialising in financial engineering, risk

¹ Constant Proportion Portfolio Insurance. This technique of asset allocation consists of defining a floor for the assets' value and purchasing (selling) the risky assets as the safety margin (total value minus floor value) increases (decreases). For more details, please see the special report titled "Principal Protection Strategies for Alternative Investments" published on 19 August 2004 and available on Fitch's website, www.fitchratings.com

² The portable alpha concept allows to distinguish alpha generation with economic exposure. Using synthetic instruments like futures or swaps, it is possible to transfer any alpha on any reference (equity, 10 year maturity, 5 year maturity, etc).

³ It is worth noting that the alpha can be generated in an asset class different to that invested. Indeed, thanks to the portable alpha concept, it is possible for example to transfer hedge funds or a credit portfolio's alpha on an equity index.

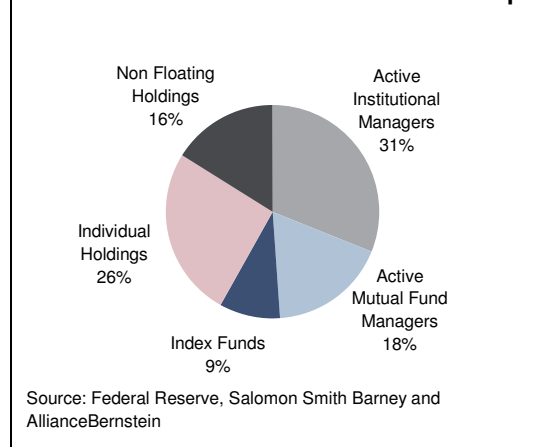
management, structuring, asset-liability management, and manager search and evaluation.

Is Active Management Achievable?

Some investors may view the right half of Chart 1 as unrealistic, maintaining that alpha is nil on average and even possibly negative once fees are taken into account. Such opponents to alpha believe very strongly in market efficiency and argue that even if some market inefficiencies exist, what is gained by one active investment manager is lost by another and thus, on average, active managers cannot generate alpha returns. Further, this view holds that market capacity to deliver alpha is finite and the growth in the volume of capital chasing alpha returns is itself reducing the market inefficiency opportunity set. Of course, this view is founded on the assumption that all, or nearly all, investors are actively seeking outperformance.

However, a breakdown of investors in the US (similar figures can be obtained for other markets) demonstrates a countervailing assumption. Chart 2 shows that active managers hold only half the issued in the US. The other half represents strategic buy-and hold stakes, individually-owned holdings which are generally passively managed, and holdings in index-linked funds. Therefore, some investors believe that the passive half offers the active half sufficient market inefficiencies to warrant efforts to identify alpha generating strategies and manages. The question for these investors is not whether alpha can exist in the current environment but rather whether it will be sufficient to offset the various costs to the manager and investor (manager selection) and whether the risk taken by the active manager (the active risk) will be properly rewarded.

Chart 2: Breakdown of the US Market Cap



Fitch's view on active investment management is that it can generate alpha, but for investors seeking

to garner such returns, they will have to meet the increased demands for greater scrutiny of investment products/strategies and the managers offering such products and strategies. As noted earlier, when expected returns are the double-digits, the thirst for alpha quells. However, when returns approach an actuarially-imposed minimum threshold or are deemed to be less than satisfactory by investors, 50 bps of out-performance can prove to be sufficient alpha to warrant an active search to achieve such returns.

Alpha Generation

As discussed by Grinhold and Kahn [1999], alpha is a function of three distinct factors – skill, breadth and tracking error⁴. Before discussing skill and breadth, it is worth noting that alpha is proportional to the active risk taken by the asset manager (e.g. the tracking error). In other words, for an unconstrained investor, greater active risk is more preferable to less. Notably, accepting greater active risk means that underperformance is tolerated within the investment horizon. Warren Buffet has proven that time is the most valuable commodity to a portfolio manager⁵. Beyond active risk, how does an asset manager improve alpha?

As mentioned above, it is a function of skills and breadth. Breadth refers to the number of independent active bets taken in a portfolio. The countervailing force to be managed when seeking to achieve breadth is correlation. For example, in recent years, taking long positions in USD and EUR interest rates was merely a single bet as both yield curves were highly correlated. In certain circumstances, when the market is influenced by very few factors without discrimination⁶, it becomes very difficult to take independent bets. Breadth is often more important when managing money than skill itself. To illustrate, a straightforward computation shows that to achieve the same information ratio⁷ as an equity manager with 30 independent bets, a EUR government bond manager with basically two bets (duration and curve positioning) has to be almost four times sharper. All else being equal, improving one's capacity to

⁴ More specifically, alpha can be expressed mathematically as:

$$\alpha = \text{skill} \cdot \sqrt{\text{breadth}} \cdot \text{tracking error}$$

⁵ From 1965 to 2003, Berkshire Hattaway Inc. has outperformed the S&P500 by 12% p.a. Annual tracking-error against the S&P500 has been 14.5%. The worst relative performance was realised in 1999 with -20.5%. Source: 2003 annual report

⁶ Such a situation occurred in the early 2000s when the NASDAQ was by far the most important driving factor. Multifactor analysis shows for example that, at that time, oil stocks were driven more by the NASDAQ than by the oil price.

⁷ The information ratio is defined as the ratio of alpha over tracking error, or put differently, the overperformance generated by unit of active risk.

generate alpha requires multiplying independent bets and sources of value added by investing in various asset classes and within them chasing specific risk rather than directional risk (e.g. not betting on the beta or on the three/four main sectors). This approach, of course, requires greater resources to analyse new regions, issuers or instruments. This also requires that investors and asset managers monitor breadth carefully, or expressed differently, specific active risk, using appropriate risk models.

Skill, the holy grail of investment management is, in the end, the ability to make accurate forecasts with respect to market movements. An important compliment to skill is information advantage. This explains why investors increasingly explore asset classes that are new or out of favour in their efforts to capture alpha returns: emerging markets, commodities, real estate, non-investment grade credits and special situations, etc. Thus an important compliment of skill is specialisation, which facilitates far more depth of analysis and informed strategising on achieving greater breadth (e.g. one can research more securities more thoroughly). Recent developments in the industry have tended to favour a “boutique” organisational style, leaving room for creativity and offering substantial incentives with financial packages indexed to value added generated. Measuring value added also requires a clear segregation of responsibilities within the investment processes and a clear measurement system (performance attribution, model or real portfolio managed by analysts, etc).

Managers focused on the same or similar strategies and investment vehicles can achieve very different results. As for what separates such managers, Fitch believes that people, tools and company organisation are primary determinants. Generally, the more successful organisations for whom the alpha engine is their human capital report long staff tenure and low turn-over. Such organisations generally adopt very compact processes with few stages in the decision-making process with teams that are working very closely together.

This organisational model tends to be more likely to generate alpha and can be set as the framework in small management firms, where it originated, and in larger firms that are increasingly moving away from centralised processes. This is not to say that a people-dependant investment management process should be without the requisite controls including

close monitoring and heightened risk management. The attributes which make for an effective investment management environment are central to Fitch’s assessment of asset management organisations.

■ Conclusion

The prevailing low return environment and the prospects for its continuation for the foreseeable future have led many investors to reconsider how and to whom they delegate their investment management mandates. Over the last two decades, the model in many countries has been to delegate an entire diversified portfolio to a generalist asset manager with a limited tracking-error. In times of double-digit asset returns, active risk was not a priority objective as it was not actuarially required and was deemed not to warrant the greater downside risk.

However, current conditions have resulted in radical changes in investor tolerance for risk vis-à-vis returns. Depending on their investment objectives and their changing levels of risk aversion, many investors have come to accept greater allocations to actively managed investments, thus placing a premium on the identification and monitoring of investment managers. Some characteristics of “good managers” are emerging, such as investment breadth, agile investment management processes and emphasis on human capital. While many asset managers have made substantial improvements in their operations, particularly in operational risk (as required by various regulatory bodies), investors’ evaluations of asset managers have taken on a central role in their efforts to identify alpha-generating potential, or even simply to preserve capital.

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