Money Management

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# Asking the right questions

AMANDA RETHUS and EDWINA BEST discuss whether the age-old way of doing things is necessarily the best approach when it comes to investments.

Stop! Why do you always do what you have always done, to always get what you always have got?

Have you thought about trying a new way?

There are plenty of examples in our lives where we make assumptions that the way we have always done things is the best.

Do investors question enough? Do investors and advisers take long-held assumptions in the funds management industry and question their validity? Does diversification still work? Is managed fixed interest the best way to protect capital in an investor's portfolio? Is leverage offering the upside it promises? Is the information ratio a valid way in which to judge fund managers? And are we making the correct assumptions about planning for our retirement?

But dare we take this further still…

If we go back to the fundamental premises for investing, we see herd behaviour in investment.

Under certain circumstances, fund managers simply mimic the investment decisions of other managers, ignoring substantive information.

Although this behaviour is inefficient from a social standpoint, it can be rational from the perspective of managers who are concerned about their reputations in the labour market. So what assumptions might they be taking for granted?

One premise on which the vast majority of investment decisions are based is that by diversifying your portfolio across multiple asset classes, when part of your portfolio underperforms this will be offset by other assets that are outperforming – the 'don't put all your eggs in one basket' approach to investing.

This approach has its basis in the theories of Harry Markowitz.

He showed that it was possible to reduce the total risk of investment portfolios by mixing the proper quantities of risky assets.

The notion that mixing risky assets can result in reduced risk caused a revolution in thinking about portfolio construction.

Markowitz's theories were developed 50 years ago and, for the most part, investors assume that they still hold true today.

However, over the past several years global markets have become more correlated with one another.

According to Merrill Lynch, over the past five years the Russell 2000 Index of Small American companies has a 94 per cent correlation with the S&P 500 in New York.

More alarmingly, international markets have not offered any diversification either: they have shown a 95 per cent correlation with Wall Street's S&P.

Hedge funds have recorded a 94 per cent link with shares, and even US property has had an 81 per cent correlation with shares.

Why should this be?

Part of the reason may be because technology and financial innovation make it easier for advisers to invest their clients' portfolios globally.

It used to be that investors had to buy foreign shares in very expensive and cumbersome ways on foreign markets, usually with sparse available analysis.

Now, advisers and investors can buy index funds in distinct countries and in distinct regions.

In this way, an investor can buy at low cost and diversify just as the world economy is diversifying.

Investors can also buy exchange-traded funds – an even nimbler, leaner offshoot of index funds – whether for emerging-market nations or for developed nations. Because these funds allow a play on growth abroad as well as a bet against sliding currencies, they provide the investor with a vast array of opportunities.

Other innovations include online trading at a low cost and online access to research reports. The list goes on.

Markets may also be more correlated with one another because, in the current global environment, there is excess liquidity, and not so many opportunities to generate returns.

The unrelenting search for uncorrelated assets has coincidentally forced 'uncorrelated to become correlated'.

According to Goetzmann, the correlation structure of world equity markets has varied considerably over the past 150 years, and is high during periods of economic integration.

Goetzmann and his fellow researchers split diversification benefits into two parts: one component based on variation in the average correlation across markets, and another component based on the variation in the investment opportunity set.

From this, they concluded that periods of globalisation have both benefits and drawbacks for international investors. Globalisation expands the opportunity set, but as a result, the benefits from diversification rely increasingly on higher risk investments.

To properly diversify a portfolio we need to re-examine the assumptions upon which that diversification is based.

There are no guarantees that portfolio diversification will work in each market cycle and on your schedule.

It's therefore safe to say that while correlation figures may still be a diversification guide, diversification

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requires more research and analysis than it perhaps did in the past.

And before investors diversify, it might be useful to determine the risks they are trying to avoid.

What about other assumptions used in portfolio management? There are many more and we will raise a few others.

For example, for many years it has been widely recognised and documented that the dominant risk in almost all larger portfolios is market risk, while the active risk contribution to the overall portfolio risk is quite small. Portfolios have therefore been structured accordingly.

This risk allocation, however, is optimal only if there is wide agreement that active management is likely to lead to a small but positive net alpha.

In fact, it is unlikely that this behaviour represents remarkable conformity among fund managers about market inefficiency and their inability to add value through risk selection.

Rather, this behaviour is based on historic assumptions that this is the most effective way to invest.

What about the generally accepted assumption that increased risk in portfolios generates more alpha?

Alpha can be defined as the difference in return between the results of active management and an appropriate benchmark for a manager.

In the expression 'search for alpha', there is an implicit expectation that alpha is out there, though difficult to find, otherwise we would not have to 'search' for it.

Mostly, we assume that the search is successful. What if the primary premises of alpha and other cutting-edge strategies turn out to be flawed or unsustainable?

Alternatively, what if you could generate alpha from more sources than is currently thought?

While it is commonly assumed portfolio returns are generated largely through active alpha, in fact, returns exist along a continuum from beta, to ultimately alpha.

Today's lower return environment has caused many to seek higher returns through alternative investments.

While current offerings in the alternative space can provide diversification and the potential for higher return, are they really an exposure to a different asset class as they are assumed to be?

Amanda Rethus

One of the most prevalent alpha-adds offered by managers is leverage.

Leverage is assumed to automatically increase the potential for alpha generation in a portfolio.

Leverage, like anything else, can be misused, and many institutions are adding another layer of it at the total portfolio level, possibly without fully understanding it.

Does leverage add value to a portfolio, or do funds' overall exposure to the full array of risks, including liquidity, time premiums, and counter-party risk, negate the benefits of leverage?

This selection of investment assumptions covers a breadth of portfolio management tools.

One can't help but reach the overriding conclusion that with the increase in portfolio construction techniques comes an increased responsibility for planners to continually critically review the approaches being used in portfolios to ensure they are still relevant in current market conditions and that return is maximised and risk minimised within existing portfolio parameters.

Edwina Best

The old adage buy low and sell high continues to be more complex than it appears.

*Amanda Rethus and Edwina Best are partners in Gateway Financial Marketing. Gateway is a boutique consulting firm that specialises in providing investment marketing expertise and strategy to Australian and offshore product providers (www.gatewayfinancial.com.au).*

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