

Innovation: Used, misused and abused

In the third in a series of articles on a new report, **Amin Rajan** laments that alpha has been everywhere except in performance numbers

22

In the wake of the bear market at the start of this decade, the pensions funding crisis triggered new interest in the idea of absolute returns unrelated to market movements.

As alpha became the new mantra, too many products were flooded on to the market without due regard to client needs. Many were neither tried nor tested, by time or events.

Many hedge funds, for example, were seen as running a Ferrari with a Citroen's brakes. Their replicators went a step further and promised to deliver outsized returns of hedge funds at a fraction of the cost. Risk was stacked up like a wedding cake. The gap between the cutting edge and the rest was massive, according to a new research study looking at the needs of pension funds after the credit.*

Raising the bar

Over time, there were mounting concerns about the viability of the risk models in use: the decade had experienced too many 'fat tail' risks, which were not factored into the models.

"Don't have blind faith in history. Today, the spreads on fixed income funds are pricing in the default rate at 45% plus. That is over twice the level of 1931. This is a different world," warns Paul Price, global head of institutional at Pioneer Investments.

Against this sobering background, via our two separate surveys, pension funds and their asset managers have identified areas that need major improvements once the worst of the current crisis is over. They cover specific attributes of managers' products as well as their fee structure (see figure right).

On the product side, attributes that need urgent attention include: transparency, risk-return features, liquidity, volatility, complexity, and correlation. On the fee side, product charges are deemed too high in rela-

tion to the intrinsic value that they deliver. Asset managers duly endorse this assessment, but only a minority sees fees as an issue.

In any event, the term innovation is seen in different lights by purists, pragmatists and procrastinators:

- Purists believe that genuine innovation is well nigh impossible;
- Pragmatists believe that innovation is about being highly opportunistic from time to time;
- Procrastinators see innovation as an excuse to jack up their fees.

"Give us simplicity and realistic figures of expected returns, instead of going with the herd and promising high numbers" pleads Karel Stroobants, a well-known independent pensions director.

As a purist, however, he warns that genuine product innovation is not possible: "The basis of every product is the underlying asset class. It always comes back to the performance of that asset class. Any complexity that you add to it will, for sure, cost money with no certainty of extra returns. Too often, these 'innovative' products are only used to hide a risk which the innovator himself is not aware of. If you cannot take the risk of the pure asset class then stay out of it. The free lunch does not exist."

However, as a pragmatist, Jean-Francois Pinçon, head of international client development and member of the executive committee at Credit Agricole Asset Management, sees things differently: "As long as you have skills, innovation is possible. It requires the combination of skills, market anticipation and understanding of clients' objectives. For example, there is a lot of value in credit markets as well as

pricing anomalies that can be harvested. But very few investors are ready to take the risk."

Then there are procrastinators who have pushed out too many 'me-too' products in the name of innovation, some requiring long lock-ins. They have attracted funds by a clever deployment of hype that has variously played on investor greed and fear in equal measures. After all, most investors are always chasing the next rainbow: so, making promises is a lot easier than delivering them. Their business model is based on a simple formula that that success is about fooling most of the people some of the time:

Returns = mediocrity + hype

Choosing to be anonymous, the CIO of a large French pension fund observed that "in this decade, many risk takers have taken their profit and gone. The originators of risk are not in the business of holding it. That job has fallen on investors like us who have to be prepared for the long haul. We are very cynical of the word 'innovation': it stands for the next con trick to fleece clients."

Both purists and pragmatists, as a result, agree that fund diversification only means one thing: you cannot lose everything at once. Its success rests on understanding the interplay between different asset classes at the most granular level; duly focusing on critical features like risks, returns, volatility, transparency and liquidity. It is unwise to put all your eggs in one basket. But it is foolish to spread them over bottom-

less baskets. There is a growing acceptance that diversification is not a panacea because experience bears out the simple formula:

Returns = Managerial skills + Fund governance / Spread of assets

Concluding remarks

Too many new products have been rushed out without much regard to their inherent value. Many are simply the resprayed version of the old. That is not innovation.

Innovation means creating new ideas that add value to clients via investment strategies that scale with greater predictability in outcomes, as with other products like cars and air travel. In sum, innovation is about creating new products that are fit for purpose: with deliverables that are sustainable and predictable.

For example, innovations that underpin the design of DC funds have to deliver capital protection as well as targeted growth. Across Europe, there are real concerns that if the new generation of DC products fails to meet these two imperatives, the regulatory backlash could be crippling, at a time when governments are weaning their citizens off state run pension schemes.

Prof. Amin Rajan is CEO of CREATE-Research.

* 'DB & DB Plans: Strengthening Their Delivery' is available free from amin.rajan@create-research.co.uk and www.ipe.com/whitepapers

In which areas do asset managers need to make significant improvements, if they are to receive mandates from pension funds in the future?



Source: CREATE-Research 2008

Case study of a UK asset manager

"The rhetoric of the investment world is solutions, but the reality is products. Investment is a cyclical business, driven by greed and fear. When one strategy fails to deliver, the temptation is to do something different in the name of innovation, as has happened with alternatives in this decade. In pursuit of higher fees, the speed at which many asset managers have switched

from relative to absolute returns – via repackaging – has been breath-taking.

Part of our problem is that we get engaged with trustees after the mandate, not before it, when the key decisions on asset allocations are made; and even then, our contacts with them are mostly through consultants. That's because we sell products, not solutions, under the existing arrangements

in the UK and Ireland.

We don't know enough about the circumstances of individual pension plans, their strategies and their funding levels to devise a solution. We're given a mandate within our area of specialism, with little guidance on how we fit into the wider picture. We find this worrying because we are one of the largest institutional managers in the world with broad capabilities. Yet, we are pigeon-holed with very little

contact with end-clients or the other managers serving them.

In a sense, that suits us: we get greater operating leverage from selling products than solutions, since products are scalable across a number of clients, whereas solutions are uniquely customised. But we could create a lot more value if we had deeper relationships with our clients. The current crisis requires a more joined up approach."