



Prof. A. Rajan is CEO of Create, a research consultancy specialising in the emerging business models in fund management.
E-mail: amin.rajan@create-research.co.uk

The 2000-3 equity crash was a defining moment. People discovered that relative returns could not buy grocery in the bear market; nor could they prevent an unprecedented shortfall in pension plans worldwide. So devastating were the losses that a bloodless coup followed in which absolute returns swiftly displaced relative returns as the leitmotif of investment. The shift was underpinned by two factors.

First, in the light of the crash, it was clear that relying on the equity markets to protect and grow one's wealth was akin to relying on a one trick pony: assets had to be diversified. At the same time, markets were rife with price inefficiencies that had long remained unexploited until hedge funds emerged on the scene in the late 1990s. With more active strategies, so the argument went, it should be possible to capitalise on mispricings, irrespective of market conditions and deliver absolute returns. This argument gained currency as hedge funds continued to report stellar returns in the early part of this decade.

Second, the time honoured 60:40 equities-bonds mix had turned out to be too risky: in hindsight, it put all the eggs in two narrow baskets. That strategy was buried by the sheer of the bear

Why diversification is easier said than done

By **Amin Rajan**

Whatever the ultimate fall out from the latest credit crisis, one thing we know for sure: there is no such thing as uncorrelated returns

market. In the meantime, a number of other asset classes had been gaining traction as a part of a wider search for uncorrelated returns. Apart from hedge funds, they included real estate, infrastructure, private equity, structured products, commodities and currency.

Not surprisingly, therefore, at the start of this decade, diversification became the universal mantra. A vast array of products soon appeared on the shelf. They aimed to spread risks and jack up returns irrespective of market conditions.

But the July crisis showed all too clearly that global stock markets were not immune from the sub prime fiasco in the US and the buy-out boom. It also exposed risks associated with diversification out of mainstream equities and bonds.

The whole episode has shown that the world of investment can be cynical. Securitisation of mortgages has only enriched intermediaries: leaving many mortgage holders

homeless; many securities holders hopeless; and many central banks clueless. Via clever financial alchemy, a few have managed to fool the many.

It is too early to know the true extent of losses or the identity of their victims. However, anecdotal evidence suggests that neither pension funds nor retail clients are likely to be high on the casualty list. Having suffered the worst body blows in the 2000-3 bear market, both these groups have wised up, according to a CREATE-Research study published last autumn.

PENSION FUND CONSTRAINTS

It shows that the last bear market savagely exposed the scale of the funding crisis, thereby damaging many reputations and weakening the covenant between pension trustees and plan sponsors. As a quid pro quo for extra contributions towards the persisting deficits, plan sponsors have been demanding that further

CASE STUDY

THE CHAIRMAN OF A UK PENSION FUND ON DIVERSIFICATION

Many pension funds are still very domestic oriented. Their covenants restrict them from going into asset classes for which they have neither the governance nor the investment expertise. Besides, having lost a ton of money in what was the longest bull market in memory, they are understandably cautious.

Many of the new investment ideas – like hedge funds and private equity – are unproven at best; and fads at worst. Many trustees perceive them as old wines in new bottles. They want to see some tangible results before they commit their money.

They find it so hard to believe that so many new strategies have suddenly

appeared from nowhere. They've been fooled in the past. So, they take everything with a large pinch of salt.

Fund managers' rhetoric of alpha is far removed from reality. And, what's more, they are often surprised when we challenge their black box approach to diversification or adjust their performance to allow for the mean reversion effect.

Yes, we do diversify but only into strategies that have stood the test of time. Ironically, we found that staying in equities over the last four years has raised our funding levels by over 40%. Sticking to the knitting has served us well.

AT THE START OF THIS DECADE DIVERSIFICATION BECAME THE UNIVERSAL MANTRA

diversification should be targeted at stress and road tested strategies.

Regulators, too, are demanding a more risk-controlled approach to under-funding. The new mark-to-market accounting rules, now being implemented on both sides of the Atlantic, is injecting unpalatable volatility into the balance sheets of plan sponsors.

FOUR KEY CONCERNS

Concerns are inherent in alternative strategies and the ways they are delivered, but hedge funds now account for 40% of the total value of assets in the alternatives universe – including structured products – now estimated at US\$5 trn.

Most pension funds have four concerns about hedge funds: high charges, shortage of prime capacity, opaque strategies and absence of governance structures. These have not deterred ultra high net worth clients and family offices, who have largely driven the growth of hedge funds in the past ten years.

Accordingly, pension funds want to see steep improvements in risk-return characteristics of the alternatives, as covered by hedge funds, private equity; and, to a lesser extent, property and commodity funds.

Improvements are deliberate. To plan sponsors, the conventional method of representing investment returns within a bar bell framework is too theoretical.

When sponsors examine the actual returns, it resembles a random distribution rather than a bar bell. The gaps between theoretical and actual returns can be big and most of the returns remain market-driven rather than skills-driven. Bar bell is thus seen as a clever marketing tool to lure investors into high fee products.

RETAIL CLIENTS SPOILT FOR CHOICE

Outwardly, Joe Public has never had it so good. With over 28,000 share classes on offer in Europe, he has five times as much choice as his peer in the US. Clients are wising up. They see many products churned out in the name of diversification as a game of new lingo and fads.

They are also recognising that fund distribution is heavily conflicted. In particular, banks acting as intermediaries automatically place funds with in-house managers or those who offer highest upfront commissions. Where the distributors are independent financial advisers – as in the UK – they are neither 'independent' nor 'advisers': sales commissions drive the choice of products and providers.

As a result, retail clients have increasingly gravitated towards a new generation of gatekeepers with a primary oath of allegiance to their end-clients; deploying institutional quality tools to allocate assets, select managers and for performance analysis. In the place of a basket of isolated products, they now offer packaged solutions. Above all, diversification is a matter of judicious choice, not a sales gimmick.

PACKAGED SOLUTIONS

This trend is largely driven by DC plan holders. Most of them don't want a lump sum on retirement. They want the same benefits as DB plan members. This would entail closer collaboration between fund managers, investment banks, insurance companies and health care providers. It would require fund managers to grow the pension pot to a level at which it can replicate the DB plan benefits. It would require diversification but failure to deliver it may involve huge reputational risk.

More generally, if fund managers continue to preach the benefits of diversification, they will have to deliver them at charges that Joe Public can afford. Currently, many investors see diversification as a hit or miss affair, shrouded within a multi-layer charging structure. While its logic remains alluring, its outcomes are uncertain. **TfB**

AMIN'S ADVICE

How to create crisis-proof credibility when diversifying...

» BUSINESS DEVELOPMENT

CEO

- Don't dilute your core areas of strengths: your clients want you to focus on what you are good at
- Avoid chasing the next rainbow at any cost: the investment world needs to rebuild its credibility after the recent debacles
- Ensure that you have the structure, skills, culture and incentives essential for success; should you decide to diversify

» OPERATIONS

COO

- Put a robust valuation process in place: many absolute returns strategies using derivatives are too opaque
- Deliver operational excellence: clients want new products to be backed by a value-for-money fee structure
- Ensure that any back office outsourcing minimises politics and personalities: otherwise gaining operating leverage will be hard

» INVESTMENT

CIO

- Ensure that you 'seed' the strategies you're diversifying into: a track record is essential
- Align the interests of your portfolio managers with your clients: it is essential that any diversification is a win-win for all
- Deliver a consistent replicable performance: most clients despise volatility even if it delivers periodic high returns
- Ensure that new strategies are scalable: their costs often exceed benefits beyond a certain level of demand

» KEY SUCCESS FACTORS

- Institutional and retail clients know all that shines is not gold. Bin strategies that may look gimmicky and make sure there is a track record you can reassure investors with
- Keep it scalable
- Make sure client and portfolio manager goals are as aligned as possible and resolve any conflicts of interest
- Consider whether you can really offer a risk-return improvement in the alternative space