Feature

THE RIGHT CHOICE

There has been much speculation about how asset allocation may be changing as consultants, institutional investors and members grapple with dismal super returns. *KangaNews* examines the numbers and how they may be driving significant changes in how assets are defined.

BY KIMBERLEY GASKIN

According to data from Super Ratings, balanced super funds – through which four out of five Australians save for retirement – lost over 17 per cent of their value over the *annus horribilis* that was 2008. The rolling five-year median looks more impressive – still in positive territory at 4.7 per cent for the average balanced fund – but the explosive years of 2003 to 2007 are about to drop out of that all-important five-year return, which may tilt sentiment accordingly.

Results from the first quarter of 2009 look somewhat encouraging on the back of an equities rally, with the 12 months to March 31 steady at -17.35 per cent and the month of March a good one with the average balanced fund gaining 2.24 per cent.

But it is too early to rejoice, says Jeff Bresnahan, managing director at Super Ratings in Sydney: "While strong in real terms, it was somewhat below the expectations given world share markets surged over 8 per cent in the month. Fund returns appear to have been impacted by a rising Australian dollar (for hedged positions) and the ongoing revaluations of listed assets."

Overall, the returns have sparked a chorus of howls from regulators and members alike. They've also instigated a period of soul-searching from all industry participants regarding both asset allocation and just exactly how growth and defensive assets are defined.

Consultants and investors are certainly reconsidering the asset mix and how best to ensure funds are 'true-to-label'. They are also cocking an eyebrow at the range of returns recorded, with the average difference between best and worst balanced funds around 16 per cent, with the worst at -28 and the best at -12. The range is even more pronounced in the beleaguered property sector, where the best performers posted a positive return of 6.3 per cent and the worst a whopping 53 per cent loss.

Comments Shane Oliver, Sydney-based chief economist and head of investment strategy for AMP Capital Investors (AMP Capital): "The variation of returns has been quite profound, which may end up driving more switching between options within funds and even more switching between funds than we have yet seen."

FUND LIQUIDITY ISSUES

Trends over the last 12 months, and particularly since the collapse of Lehman Brothers in September 2008, have been driven by the need for liquidity in portfolios. In part the liquidity imperative has been based on factors unique to the Australian superannuation market – that is, the existence of Member Choice and optionality within defined contribution plans, including master trusts, which in and of themselves include dozens of options.

The Choice initiative certainly contains the seeds for both catastrophe and conservatism, given members can switch their allocations at any time, moving away from the traditional default option of 70 per cent growth assets and 30 per cent fixed income for a balanced fund. On one hand there has been fear that the disastrous equities experience could drive excessive risk-taking to make up for losses. On the other, the fear is that

"The high weighting of credit in the UBS Composite Bond Index has created a problem for the 'defensive' portfolio because corporate debt has a big equity element."

SHANE OLIVER AMP CAPITAL INVESTORS

an era of excessive conservatism may ensue, expressed through wholesale switching into cash.

Comments John Stroud, an independent investment consultant who has worked with some of larger asset consulting houses in Australia: "Member Choice and the choice within funds have definitely created pressure for funds to be more liquid. This has underpinned a tendency for super funds to be somewhat more biased towards cash allocations than would be normal within asset allocation. The more important issue is it has made some commercial superfund product providers more reluctant to allocate to unlisted assets."

While this certainly has administrative challenges, it also means some super funds were somewhat less exposed to very illiquid assets and relatively more cashed up heading into the global financial crisis than they might otherwise have been. Says Andrew Harrex, Melbourne-based principal at Mercer (Australia): "Some funds are more liquid than they would have been if it wasn't for Member Choice. The prospect that members could move to cash or equities and back again with the click of a button has driven the need for more liquidity than would otherwise be required, which has historically served a number of funds very well."

The mind shies away from thinking about just what might have been if Member Choice hadn't created a certain liquidity drive. According to data from Chant West, on average the industry has 10 per cent invested in illiquid assets – defined as unlisted and direct property, private equity and infrastructure. The top eight performers in 2008 had a whopping 27 per cent in illiquid assets.

LIQUIDITY AND CURRENCY

Liquidity pressure isn't just a function of members wanting to either redeem or switch allocations, however. Another critical issue has been the need for liquidity to support rolls on currency hedges thanks to the big fall in the Australian dollar, which moved from a high of 97 against the US dollar in July 2008 to a low of 61 in November and towards the end of May 2009 was at around 75. "This created a massive cash flow drain on some funds and many had to find significant levels of cash," says Tony Arnold, Melbourne-based head of Australian fixed income manager research at Watson Wyatt.

There has been no shortage of debate over the strategic role of currency hedging but the real issues now are more operationally focused – that is, the cash flow consequences of currency hedging and having access to liquidity to fund hedged positions when the AUD falls, and the wisdom of hedging illiquid assets – including those that appear relatively liquid – within pooled vehicles.

According to Bresnahan at Super Ratings, the huge performance differential between international share funds was driven largely by hedging positions, with the international shares options with fully hedged exposures to the Australian dollar returning up to 10 per cent while funds without currency management may have lost over 2 per cent. "This result has a flow-on effect to the performance of balanced options, which can typically have 25 per cent invested in international shares," he says.

There is ample evidence that funds are taking currency management very seriously, on a whole-of-portfolio basis too, not just with respect to individual asset classes. In May National Australia Bank surveyed 34 of Australia's largest superannuation funds, representing some A$315 billion (US$247 billion) of funds under management, and found that 85 per cent of funds rank currency as an important or very important issue, compared with 74 per cent in 2007. Some 24 per cent of funds now look at currency on a portfolio basis compared with just 6 per cent in 2007.

Around 41 per cent of funds are now reviewing currency issues quarterly compared with 20 per cent in 2007, while 9 per cent are reviewing monthly now compared with zero in 2007. The old annual review style is certainly withering on the vine. Where 66 per cent of funds reviewed currency strategy annually in 2007 only 29 per cent do so now, in favour of much more frequent analysis.

ASSET ALLOCATION 2006 – MARCH 2009

YEAR	CASH	AUS. EQUITY	INT. EQUITY	AUS. FIXED	INT. FIXED	DIRECT PROPERTY	LISTED PROPERTY	MORTGAGE	OTHER
Mar-09	11.23	31.40	25.92	12.21	6.15	1.10	8.70	1.73	1.62
2008	10.83	32.65	27.65	10.57	5.37	0.95	9.11	1.67	1.21
2006	11.15	32.48	25.99	14.35	5.18	1.16	8.50	0.59	0.60

SOURCE: MORNINGSTAR MARCH 2009

SYSTEMATIC LIQUIDITY *MISMATCH RISK*

TROUBLE FOR ONE CAN MEAN TROUBLE FOR ALL. HOW IS THE INDUSTRY MANAGING CONCERNS ABOUT SYSTEMIC LIQUIDITY MISMATCH RISK?

Individual liquidity issues – Member Choice, currency catastrophes and asset reallocation – are problematic, but they point to an even more significant issue that consultants need to come to grips with. That is systemic liquidity mismatch risk – the risk that one fund's inability to meet at-call obligations created by Member Choice or other liquidity pressures may blight the entire industry.

Part of the problem is that the benefit of running a mismatch – the higher return generated by more illiquid assets – only accrues to the individual fund, but the risk is essentially borne by all industry participants, regardless of their approach to investing in illiquid assets.

Says Simon Eagleton, business leader, investment and consulting at Mercer: "High liquidity mismatch risk in a single large super fund creates externalities – or costs – on all other super funds, even those with only limited liquidity mismatches. The full costs are borne by the entire industry; the competitive marketplace means no individual fund is incentivised to act to reduce the systemic risk."

Tony Arnold, investment consultant, manager research at Watson Wyatt, says there will always be funds that migrate to extremes, potentially with the full backing of their membership, but which can cause problems in an environment of account balance portability. "But as long as the regulator oversees the industry well and is able to be flexible if cases of extreme stress do occur – for example, by facilitating fund mergers – the risks at an industry level are low," he adds.

Other potential regulatory solutions include public disclosure of liquidity positions, limits on allocation to illiquid instruments and access to external emergency liquidity. "But regulatory intervention is sub-optimal," says Eagleton. "A voluntary code of conduct to reduce liquidity mismatch would be preferable." Voluntary measures that could help manage systemic risk include fewer unlisted assets, less flexibility in switching options, changes to redemption process – such as minimum notice periods and early withdrawal discounts – and disclosure of liquidity issues.

"A key question we now ask is: how do we manage our currency hedge when currencies are falling or rising when the underlying assets are doing the same," says Scott Tully, head of FirstChoice Investments at Colonial First State in Sydney. While FirstChoice maintains a passive view on currency, he agrees that the issues are now under the microscope and the review process is much more frequent.

ALLOCATION RESPONSE

That liquidity pressure has been on is indisputable, but just how has asset allocation shifted in response?

The collapse of equity markets following the Lehman debacle clearly threw allocations out of whack, with illiquid assets such as property and infrastructure swinging into overweight as equity percentages dived with the market. And some institutional fund managers have blamed Member Choice and other liquidity issues for the liquidation of relatively well-performing fixed income assets so as to rebalance the equities portion of some portfolios as equity markets fell in 2008.

Consultants and investors alike report some build up of cash over 2008 and while there certainly was some selling of the liquid portion of fixed income portfolios – government and semi-government bonds – investors do not believe the fixed income portion of portfolios has been too harshly punished for being liquid. As Nick Tribe, Melbourne-based deputy head of fixed income at Aviva Investors points out, many funds have had relatively high proportions of their fixed income allocation in highly illiquid credit vehicles or mortgage trusts. "That would have made rebalancing through selling out of fixed income very difficult," he says.

Tribe believes some of the selling of liquid fixed income instruments may in fact be attributed to historically low yields on government bonds, which have been impacted in terms of spreads by the government guarantee extended to domestic bank bond issues. "The sale of governments and semis over the last six to nine months has really been about investors looking for better value options in other bonds as opposed to just thoughtlessly selling the most liquid assets first in order to rebalance," he says.

Asset consultants confirm that selling of fixed income to rebalance to equities has not been endemic. "Although it has occurred in some cases, we wouldn't recommend locking in losses in credit to fund equities," says Ashley O'Connor, consultant at Frontier Investment Consulting (Frontier) in Melbourne. "We recommend that rebalancing into equities occurs as new cash flows and contributions come into the fund and that is what has been happening for those clients that have built up appropriate cash liquidity."

According to data from Morningstar, the numbers are not wildly different between 2006 and year to date 2009. Cash is very slightly up after a small dip in 2008; fixed income, at a combined total of 18.36 per cent, is very slightly down on the 19.53 per cent recorded in 2006. There is a 1.1 per cent difference in equities holdings, which were slightly higher in 2006 (see table on p11).

A modest share rally in the first quarter of 2009 has eased any pressure to rebalance. However, the question of just how rebalancing should be managed remains crucial, particularly with some tough years still ahead and equity market volatility likely to continue for some time. Market participants remain divided as to how rebalancing should occur in a situation of severe stress.

"Australians should have a long-term investment horizon as much of their savings are in superannuation. This naturally tilts investments to shares and property and away from fixed income and cash."

SCOTT TULLY COLONIAL FIRST STATE

DEFINING ASSETS

Debate is also raging about how liquidity and illiquidity should be defined and, by extension, the definition of growth and defensive assets. Comments AMP Capital's Oliver: "The default 70:30 split between growth and defensive assets has been maintained for many years in the Australian market. But lines have blurred in terms of what is growth and what is defensive, leading to some pretty significant portfolio losses."

A key development over the last five years has been the inclusion of a new breed of assets – alternatives – supposedly less correlated to equity markets in the defensive portion of portfolios and even in some cases in the fixed income bucket. These include direct and indirect property, infrastructure, private equity, real estate investment trusts (REITs), hedge funds, private sector debt and other credit-based instruments such as risky securitised bonds like collateralised debt obligations (CDOs) and collateralised loan obligations.

In financial year 2007-08 alternatives, excluding credit-based instruments, accounted for 13 per cent of the defensive part of portfolios across the balanced fund universe in Australia, up three per cent on 2006-07, according to data from investment research firm, van Eyk. While data on the average portion of credit and other alternatives in the fixed income portfolio is not available, the very fact that credit accounted for 43.1 per cent of the UBS Composite Bond Index – this includes a 21.2 per cent allocation to sovereigns and supranationals – suggests that allocations to this asset class were relatively high.

Janice Sengupta, chief investment officer at Aon Consulting (Aon) in Sydney, says it is not empirically justifiable to view all fixed income sectors as equally defensive. "A particularly important issue is whether the broader fixed income portfolio is still truly defensive. Introducing broad mandates or using sector specialists in emerging debt, high yield, mortgage-backed securities and credit in a portfolio can substantially change the risk-return characteristics," she says.

As for the correlation issue across the range of alternative assets and some fixed income assets, the numbers speak for themselves. Private equity funds are standing on losses of around 20 per cent; many CDOs have lost most of their value; corporate credit-related investments had losses ranging up to 26 per cent for US high-yield debt; REITs lost 70 per cent to 80 per cent of their value and hedge funds 20 per cent of their value over 2008.

GROWTH vs DEFENSIVE

Nigel Wilkin-Smith, Sydney-based head of the strategic research unit at van Eyk, says: "The lesson here is funds need to be much more careful about what is defined as growth and what is defined as defensive. Many alternatives have proved to be much more highly correlated to equities than imagined, which makes their status as defensive very questionable." This relates to liquidity as well as return, with the increasingly higher allocation to those alternatives dragging down the defensive portion of many portfolios and at the same time proving to be much more illiquid than expected at a time when liquidity is at a premium.

Many market participants are asking whether classifications themselves need to change. This is a particularly important issue given comparisons between funds can be impacted by their definition as either growth or defensive, even though there may be wide variation in the underlying portfolios depending on the individual fund's view on what should fall into those two categories. The confusion over categories has become so pronounced that The Association of Superannuation Funds of Australia (ASFA) has opened discussion as to whether the words should even be retained when it comes to fund description. "Many superannuation funds have expressed concern regarding this lack of consistency and the misleading comparisons that result," the association comments.

To address this vexed issue, in August 2008 ASFA published a position paper on the classification of assets based on consultation with a wide group of asset consultants and super funds. The paper found that the greatest variation in classification occurred in the alternatives space, particularly with regard to unlisted assets in general, hedge funds and unlisted infrastructure in particular. "Unlisted property had historically been included within growth assets. However, there now appears to be a growing perception by some market participants that it is more a defensive asset than a growth asset," comments ASFA.

The paper essentially suggests a return to a more binary view of growth and defensive assets, where cash and Australian bonds – where not more than 25 per cent of the portfolio is comprised of non-traditional bonds, including sub-investment grade debt, unrated debt, emerging country sovereign debt and unhedged international bonds – are considered defensive and everything else – including unlisted core property, infrastructure, timber and hedge funds – is considered growth.

"Some secondary risks may not have received much attention prior to the credit crisis, but became painfully manifest once financial institutions began to express stress."

JANICE SENGUPTA AON CONSULTING

ASFA POLARISES THE MARKET

The paper has polarised the market, with some welcoming the stricter classification. Says Tully: "Defensive assets are simply those which have a final par value. An asset that can experience a growth in capital value over time should be placed in the non-defensive bucket. ASFA's classification will make portfolio comparisons clearer and much fairer."

All industry participants agree that classification will become more binary again as those blurry edges between growth and defensive are sharpened in the quest to become 'true to label'. But some chafe at this binary view, fearing that the industry may end up throwing out the baby with the bath water. Comments O'Connor at Frontier: "We believe there should be some flexibility around asset classes like hedge funds, infrastructure and property. There is a huge array of investment types that fall into those categories and super funds should have the discretion to look through to the underlying investments to calculate a growth/defensive split that is more relevant to the clients' investments than just using blanket definitions."

Still others worry that a common standard of classification will simply veil the real issue – that fund managers need to start focusing more on identifying truly diversified opportunities that are uncorrelated. "You can argue back and forth and use buckets all you like, but funds shouldn't let this distract them from what they really need to do – hunt out assets that are genuinely different," comments Stroud. "That's the basis of true diversification."

Arnold at Watson Wyatt argues that severely restricting classification of what belongs in a superannuation fund's defensive bucket could end up constraining managers in terms of opportunities for return. "Fixed income is a continuous spectrum. You can miss key opportunities if you make it too discrete," he says.

If, for example, the defensive buckets became just cash and government bonds, managers potentially miss out on some favourable and highly-rated opportunities, particularly in the government-guaranteed financials space. "We don't want to prevent managers from buying these securities on a substitution basis. While there may be legitimate concerns about holding other forms of credit in defensive portfolios, there are plenty of opportunities in credit that should be explored and exploited, but potentially held elsewhere in a portfolio due to illiquidity and left tail risk," adds Arnold.

Apart from opportunity cost, the other real problem with a very binary approach to classification is simply that growth and defensive mean different things to members at different ages and different stages of the investing cycle. As Sengupta at Aon says: "An appropriate investment portfolio for a 30-year old at the start of their investing life versus a 65-year old nearing retirement can be very different."

Sengupta argues that rather than focusing on labels such as growth or defensive the construction of a strategy should be based on the time frame for the investment and the wealth position of the investor relative to what they want to achieve over the investment horizon. That exercise will identify the rate of return necessary and leads to possible asset allocations. The risk characteristics of the portfolio are then compared with the risk tolerance of the investor and if there is a mismatch, adjustments need to be made.

Wilkin-Smith at van Eyk also believes a move to a more matrix style of classification that considers age and work circumstances, along with more traditional descriptors of investment risk, would be a better approach than using simple buckets. "Those inputs are crucial when it comes to working out what assets represent to different members," he explains.

SPLITTING THE PORTFOLIO

No-one seems to be really focused on changing the default 70:30 ratio for a balanced fund at this stage, even though offshore models for balanced funds are far different. In the US and UK, for example, the split tends to be more like 50:50. Says FirstChoice's Tully: "Australians should have a long-term investment horizon as much of their savings are in superannuation. This naturally tilts investments to shares and property and away from fixed income and cash."

The split is not really under question even though Australia has a much lower allocation to fixed income than other countries and the global financial crisis has revealed glaring problems in overly growth-oriented portfolios. Market participants are more interested it the question of what role credit-related instruments should play in the defensive part of the portfolio going forward. Performance data provides the heft behind the question. Over 2008 Australian bonds – the best-performing asset class – posted a 14.95 per cent return, while hedged international bonds returned 9.21 per cent thanks to prudent investments primarily in sovereign and other government bonds as well as falling interest and cash rates.

Credit has been a basket-case, with the worst fund hitting minus 34.57 per cent according to Morningstar data.

> "The issue is not the mandate given to the manager but the ability to implement it properly depending on market circumstances and then depending on the manager's ability to select the right securities in the credit universe."

ANDREW HARREX MERCER

So it is not surprising that credit's role in a portfolio is under the spotlight.

While there is general agreement that a number of other formerly designated defensive assets should probably be stripped out, credit remains problematic: there is no doubt that it should be classified as debt, but it has proven to be highly correlated with equity. "The high weighting of credit in the UBS Composite Bond Index has created a problem for the 'defensive' portfolio because corporate debt has a big equity element," says AMP Capital's Oliver.

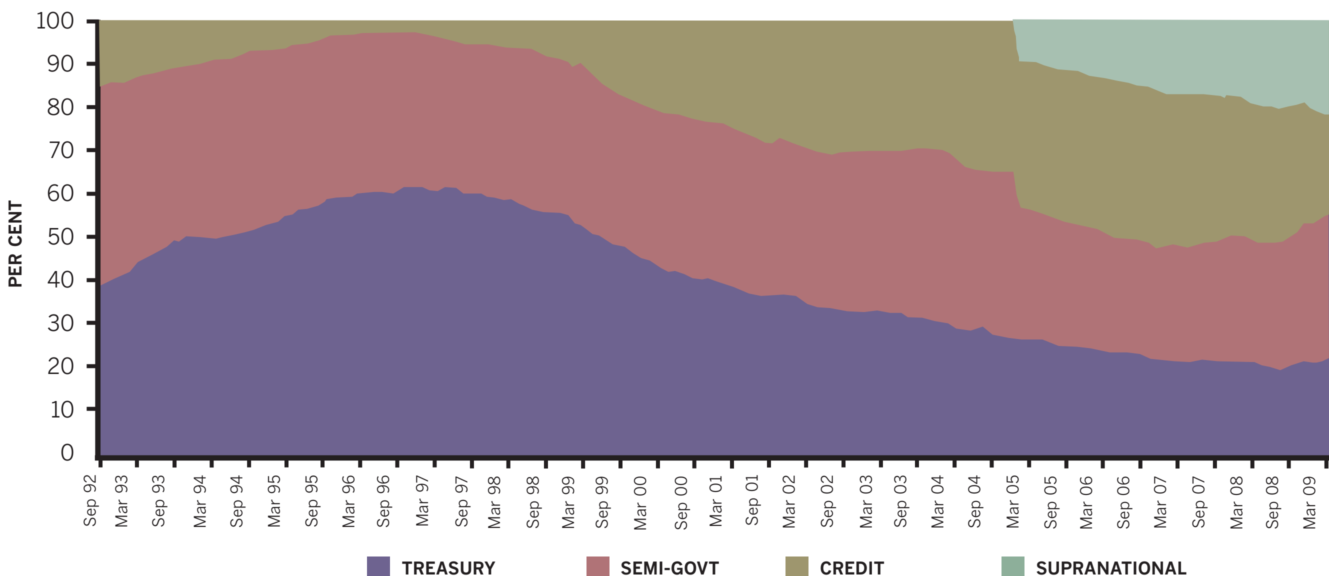
Aviva Investors' Tribe anticipates a significant change in the configuration of fixed income portfolios going forward as market participants address these issues. "You just can't allocate the bulk of your fixed income exposure to illiquid high yield, mortgage trusts and other credit-related instruments – these allocations will probably come down quite considerably over time," he comments.

In part these changes will be driven by transformations to the benchmark, which is morphing as government and semi-government issuance rises and with the big volume of sovereign-guaranteed bank paper issued since December 2008. As at May 15 the index composition sat at 57 per cent government and semi-governments, 21.15 per cent in supra/sovereign and agency paper and 22 per cent in corporate credit. This compares with May 2007 when government and semi-governments accounted for 47.9 per cent, supras and sovereigns 17 per cent and credit 28 per cent (see graph below).

There is an expectation that ongoing government and government-guaranteed issuance will continue to transform the index landscape, which will have a flow-on effect to how fixed income portfolios are comprised. This comes as some relief to some market participants. Comments Mercer's Harrex: "There was a time when the credit portion was as high as 45 per cent of the index and managers by default had to reflect that in portfolios. At the time it was unlikely that any end client requested such a high exposure to this asset class."

While the changes ahead are positive, a number of players believe more drastic action may be called for and that the capitalisation-weighted index will continue to be a thorn in the side of investors due to its composition. With respect to the index, two key issues have proved to be particularly

UBS COMPOSITE BOND INDEX: PERCENTAGE CHANGE IN COMPOSITION



SOURCE: UBS AUSTRALIA APRIL 30 2009

UNLISTED ASSET VALUATION SPARKS MORE DEBATE

THE AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY (APRA) HAS SENT A WARNING SHOT TO THE INDUSTRY ON ASSET VALUATION. BUT IS THE HYSTERIA OVERBLOWN?

Wide variation in super fund performance has given rise to significant industry debate on the value of unlisted assets. Comments Tony Arnold, investment consultant, manager research at Watson Wyatt: "While unlisted assets can be appropriate to hold in a well-diversified portfolio, the differences in fund returns coupled with the lack of consistency and clarity around appraisal-based valuations have raised a lot of questions, particularly given the increasing allocation to unlisted alternatives over the last five years."

With market conditions changing so rapidly over the last 12 months, prices on the listed side have been wildly volatile, reflecting both expectations of reduced future earnings and negative market sentiment. However, unlisted assets such as direct property, direct infrastructure and private equity, which are only valued periodically, have remained relatively stable thus far as their pricing is far less influenced by market sentiment and it can take longer to incorporate changes in expectations of future earnings. While the pricing mechanisms for listed and unlisted markets are quite different, neither is without its issues.

The relative performance of listed and unlisted property is an interesting case in point. In the 12 months to June 30 2008 the Australian listed property trust index returned -37.2 per cent while the unlisted property sector returned 14.7 per cent – a difference of some 52 per cent.

APRA is so concerned about unlisted valuation that it took the step of issuing a stentorian reminder to super funds on April 16 2009 regarding prudent practice in valuation methodology and processes.

The APRA letter focuses on timely and independent valuation, highlighting the need for robust, consistent and frequent valuation, in an attempt to discourage "valuation shopping", where funds gather a rainbow of valuations from different sources and choose the most advantageous. While APRA does not give any hard and fast rule about how often valuations should be undertaken, it reminds market participants they are required to determine the events and circumstances on which the assumptions underlying valuations would need to change, which may result in a revaluation of the unlisted asset.

"When adopting a particular valuation (whether or not internally sourced), the trustee needs to demonstrate what considerations have been made, including consistency with previous valuation exercises," writes APRA.

The letter has set many heads nodding sagely, but not all are convinced the valuation situation is as dire as indicated.

The Australian Institute of Superannuation Trustees (AIST), for example, isn't convinced the listed sector is an appropriate benchmark for the unlisted asset sector. Paul Vascotto, policy analyst, argues that while different valuation scheduling may be relevant it is difficult to believe the unlisted sector will experience as large a decline in valuations because assets in the unlisted sector are priced on the basis of a willing seller, and the listed sector is being priced on the basis of a distressed seller. In the case of the property sector, the difference is quite clear. "The listed property sector had transformed itself from a basic holding vehicle that purchased large assets, collected the rent and then passed on the rent to investors in a tax-effective way to a highly-engineered financial vehicle. This inevitably led to the spectacular decline," comments Vascotto.

While acknowledging the recent liquidity issues faced by some high-profile unlisted property vehicles, Vascotto remains confident unlisted property will continue to play a valuable and significant role in super fund investing. "One would expect the flight to cash among super fund members, coupled with the denominator effect on fund re-balancing, to put pressure on unlisted vehicles. However, investing for retirement is all about making decisions for the long term which means quality unlisted property investments with stable, secure long-term leases linked to inflation are a natural fit in a diversified superannuation portfolio," he explains.

Some industry participants have called for exposures on 20-30 per cent only in unlisted assets, but Vascotto argues that even with as much as 50 per cent exposure to unlisted assets, funds still retain a high portion of assets in the liquid asset classes of shares, bonds and cash.

"APRA is very clear that surplus liquidity would be costly over the long term due to its effect on investment returns. Trustees need to balance the fine line between liquidity and lower returns and illiquidity and higher returns," concludes Vascotto.

problematic: the fact that duration is determined by the issuer rather than investor preference, and that the biggest debtors have the largest weight in the benchmark. According to Susan Buckley, managing director of the active management division at Queensland Investment Corporation (QIC) in Brisbane: "Funds tracking a capitalisation-weighted benchmark have to purchase in proportion to capitalisation weight to minimise tracking error, even if the security is only marginally of high enough quality to make it into the index. Such securities would seem to be the most likely to be downgraded or to default."

One potential solution to this issue could be reviewing asset allocation weights more regularly. "They tend to be static for long periods, even in the face of significant changes in market valuations," says Buckley.

A related option could be decoupling active management mandates from strategic asset allocation weights, which often constrain managers. Buckley explains: "Active mandates are allocated in accordance with strategic asset allocation weights so some managers are reduced to making insignificant contributions if they manage within an asset class which has a small allocation. The strategic asset allocation (SAA) does not

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TONY ARNOLD WATSON WYATT

reflect any fundamental belief that assets with higher SAA weights can provide a higher or more consistent return.”

Mercer’s Harrex believes the best way to deal with the weaknesses in the index would be to migrate away from it altogether. “It may be time to start thinking about GDP weighting, for example,” he says.

THE CASE FOR ACTIVE MANAGEMENT

Right now all consultants and investors are focused on significant opportunities to be had in investment-grade credit, including senior secured bank loans and high-quality residential mortgage-backed securities. Meanwhile, the hunt for yield has reaped some disastrous fruit for fund managers with the main weapon – credit – turning out to be a blunt instrument.

Market participants are absolutely unanimous that active managers cannot be faulted for weak performance during the ructions of the credit crisis, particularly during times when the market was perversely punishing prudent portfolios. At times high-quality, liquid instruments were sold because there was a market for them and their prices fell more than junk assets. In fact, most believe active management can still play an important role in generating alpha.

Aon’s Sengupta thinks the market needs a renewed understanding of the market risk in any option which exists within a pure beta play. “A low-cost index fund can still have a minus 50 per cent return in global property if that’s what the market index delivers,” she points out.

A key issue has been a lack of appropriate focus on risks embedded in fixed income beta strategies – particularly counterparty and organisational risk in addition to the usual market, credit, and interest rate risk. “Some secondary risks related to operational process, compliance checking, or subtle conflicts of interest may not have received much attention prior to the credit crisis, but became painfully manifest once financial institutions began to express stress,” says Sengupta.

Mercer’s Harrex also argues that credit is better thought of as an active beta decision – as has been proven by what has happened over the period of the financial crisis. He says: “The issue is not the mandate given to the manager but the ability to implement it properly depending on market circumstances and then depending on the manager’s ability to select the right securities in the credit universe.”

THE STRUGGLE TO DELIVER OUTPERFORMANCE

There is no doubt, though, that active managers have struggled to deliver outperformance after fees over the last few years, even before the global financial crisis turned the world upside down.

The underperformance may be attributed to the use of strategies that are tied to benchmark characteristics that do not necessarily represent the optimal risk/return structure for investors. More flexible active mandates that are less correlated to the index would help, as would the establishment of an investment framework of independent alpha and beta policy decisions. “Over the medium term highly convicted fixed interest managers can deliver superior total return outcomes from a less restrictive mandate. And a separation of beta and alpha will increase a manager’s ability to generate meaningful active returns at the total fund level,” comments QIC’s Buckley.

Others are also keen to see the approach to active management change to better capture market opportunities. Frontier’s O’Connor wonders if a better strategy would be giving managers a total return mandate – that is, cash plus with no specific benchmark. “If we open up some of the traditional constraints on active bond managers we should see better performance,” he comments. But he warns that only certain managers have the right set up to pursue this option. “You would need a global manager with deep resources and a proven ability in allocating between sectors and picking securities,” says O’Connor. “At the same time, they would have to be aware that preservation of capital is paramount.” •

“Funds need to be much more careful about what is defined as growth and what is defined as defensive. Many alternatives have proved to be much more highly correlated to equities than imagined, which makes their status as defensive very questionable.”

NIGEL WILKIN-SMITH VAN EYK