

RETHINKING BOUNDARIES: IMPLEMENTING GREATER FLEXIBILITY IN THE POLICY PORTFOLIO

THE POLICY PORTFOLIO

A policy portfolio splices together component benchmarks in the same proportions as the investor's target allocation to various asset classes. Thus, it forms a total-fund benchmark that approximates passive implementation of the overall investment policy.

The policy portfolio is an important construct, one that's likely to endure as a best practice in institutional fund management. The policy portfolio preserves an important distinction in the function of portfolio management. The first goal of portfolio management is to infuse the portfolio with the proper sense of the investor's liabilities, objectives, and risk tolerance. These characteristics are fundamental and enduring, and warrant a certain allegiance. At the same time, and secondarily, portfolio management affords investors an opportunity to exploit security mispricing, which tends to be elusive.

By monitoring portfolio composition relative to the policy portfolio, the investor ensures that implementation does not lose sight of his or her circumstances. Risk-budgeting, in which active risk is controlled in aggregate and parsed among sources, is the most recent refinement to the policy portfolio's *control function*. And by comparing one's actual return with that of the policy portfolio *after the fact*, the investor can isolate the effect of active management to evaluate its efficacy. This is the policy portfolio's *performance measurement function*.

WHY THE INTEREST IN GREATER FLEXIBILITY NOW?

In "Points of Inflection" Peter Bernstein touched on a theme that is stirring considerable interest and controversy in the profession: the idea of achieving greater *flexibility* in implementing the policy portfolio. What accounts for current interest in achieving greater investment flexibility?

**This is the text of a speech by Richard Ennis at AIMR's Points of Inflection Conference in New York, NY, February 27, 2004.*

Acknowledging the Futility of Closet Indexing

The standard implementation model for large pension funds during the 1980s and 90s was to employ a large number of managers – often upwards of 20 – within narrow asset-class specialties. Most managers diversify within their area of specialization, be it large-cap growth stocks in the U.S., emerging market stocks, or a segment of the bond market. In the spirit of risk control, clients, with the help of their consultants, fashioned complex mosaics of manager style, superimposing a largely fixed template of style and factor diversification upon the managers' security-level diversification. The result was a form of implementation high in rigidity and cost, and – in the aggregate – low in active risk. It was aptly dubbed closet indexing. I cannot help but believe that disaffection with closet indexing has contributed to the interest in greater flexibility.

Evolution of Instruments and Markets

The advent of trading instruments and the evolution of markets expand opportunities to create portfolio exposures and lower transaction costs. Ever greater investment flexibility is a byproduct of this innovation.

Globalization

Globalization has contributed to greater integration of investment markets. Stock market sector factors are now as or more important than country of domicile in explaining stock returns. The distinction between "domestic" and "foreign" blurred as companies like Daimler and Chrysler merged and competition, generally, took on a truly international character. Markets that were "emerging" have been re-classified "developed" – and vice versa. European countries now share a common currency. Market segmentation everywhere is vanishing in the name of economic efficiency. Globalization demands a less parochial, more flexible approach to investing.

The Bubble

As the Internet-telecommunications bubble formed, we witnessed IPOs blowing through small- and mid-cap space to become large growth companies virtually overnight. Large-cap growth indexes, which traditionally contained a relative few percentage points of technology stocks, came to be dominated by tech. Traditional growth-stock managers were challenged to change their spots or risk being rendered obsolete. At the same time, spectacular distortions in valuation created opportunity for those less inhibited by the strictures of style: Managers willing and able to shift from growth to value in 2000 profited handsomely. Hedge funds, as a class, played the bubble just about right, effectively eliminating significant net-long equity exposures near the top. And so, in all likelihood, and for better or worse, the bubble and its aftermath have contributed to a newfound spirit of opportunism.

A Perceived Disconnect Between Risk and Expected Return

Bubble pricing brought forth an outpouring of critical thinking about the equity risk premium. Thoughtful observers questioned how stocks, yielding barely more than 1% and remaining at exceptional multiples by historical standards, even after the bubble burst, could produce a satisfactory – or even positive – real return in the years ahead. Some approached the matter with scholarly rigor while others were more matter of fact: Warren

Buffet, for example, observed late in 1999, with bonds yielding 6.7%, which the stock market looked like a fine place to earn about 6% a year for the foreseeable future.

In its most vigorous expression, concern over the equity risk premium is nothing less than a perceived breakdown in the pricing of assets, a view that stocks aren't priced to provide an appropriate return for the risk they entail. In a world such as this, were it to exist, a large and fixed allocation to equities would have no place in portfolio management.

The Rise of the Hedge Fund

Hedge funds epitomize investment flexibility. And their proliferation in the past 10 years has been spectacular. These portfolios invest without respect to a benchmark and, in principle, anyway, eliminate deadweight diversification. The growing acceptance of hedge funds, while in and of itself not an impetus for more flexibility, has become a strong source of collateral support. Thus, we might best describe the popularization of hedge funds as a manifestation of the enthusiasm for more flexible approaches.

Caveat

Some of these are good reasons to seek greater flexibility. Scrapping the use of active managers for diversification – closet indexing – is one of them. Recognizing that skill isn't necessarily narrow in scope and that markets are increasingly integrated also strike me as worthy justifications for rethinking investment approach. And if the advent of instruments and the evolution of markets increase flexibility, investors will certainly avail themselves of it.

Other arguments for greater flexibility warrant careful examination. As a secular outlook, believing that stocks won't do any better than bonds is to suggest that the market is cock-eyed. The view that bonds will do better than stocks is a market outlook, regardless of the eloquence of its expression. Skillful execution can be profitable, to be sure. But there are significant risks, as well. In the year just closed stocks produced a return of 32% and bonds 4% for an equity-over-bond premium of 28%. This outcome is inconsistent with the no-equity-risk-premium view prevailing a year ago, and investors who shifted heavily from stocks to bonds based on such an outlook suffered dearly. Betting against the equity risk premium is a strategy narrow in breadth, making both skill and risk control of paramount importance.

I hasten to add: I am not making a market forecast of any kind. Rather, I am simply reminding you of a fundamental tenet: For purposes of investment policy planning, expected return and *market* risk go hand in hand.

A truly specious justification for promoting greater investment flexibility is the notion that market returns in this low-inflation, low-interest-rate environment no longer meet the "requirements" of investors and that the only way to make up the difference is by garnering alpha. Let's be clear: Positive alphas go to those who can earn them and to those who are lucky; they are not distributed based on investors' appetite for them.

This brings us to the question of the hour: Can you achieve greater flexibility in implementing investment policy without undermining the very *function* of investment policy?

ACHIEIVING GREATER FLEXIBILITY WISELY

Institutional investors vary in asset size, resources and sophistication. Accordingly, techniques that make sense for a \$10 billion educational endowment or \$50 billion pension fund are simply not available to a \$100 million fund. I believe, however, that there are opportunities to become more flexible in implementing the policy portfolio for all types of investors. I will begin by discussing the simpler, more universal ways to accomplish this and progress to the more advanced.

Fewer Managers, Broader Mandates

To the extent investment skill exists, I don't believe it is purely *local*, so to speak, existing only – or even primarily – in connection with the appraisal of a relatively short list of homogenous securities. Nor do I believe markets are so inefficient that institutional investors can expect to profit from hiring dozens of conventional long-only, stylized specialists. Indeed, I maintain that funds have employed large numbers of such managers because they lack *confidence* in their ability to select those that will prove skillful.

I *do* believe investment opportunity is sometimes here, and sometimes there; and that skillful managers should be free to find it where it lies. And I believe some skillful managers can and do benefit from the perspective and latitude that a broad purview affords them.

The type of rigid specialization to which I object is more characteristic of domestic-equity portfolio management than it is of international equity or fixed-income portfolio management. Those areas have evolved more along the *whole-portfolio* lines that I favor for conventional investment management. Core-plus managers work in and among all bond market sectors; and non-U.S. equity managers invest literally all over the map. Thus, a prime area of opportunity for achieving greater flexibility in implementation is the domestic equity portfolio.

And let us not overlook the opportunity to break down the arbitrary boundary that exists between “domestic” and “non-U.S.” markets. Evidence of global integration tells us this just isn't right. Investors can and should be giving greater credence to *global* equity portfolio management.

Employing fewer managers with broader mandates is a relatively easy, reasonably conservative way to render implementation more flexible while reducing, rather than increasing, complexity. In this sense, it is a good place for most funds to start.

Eliminating the Long-Only Constraint

Let us be clear that all this talk of greater flexibility has to do with exploiting security mispricing; we can get any form of market exposure we want reliably and cheaply with passive portfolios and derivatives. And as for

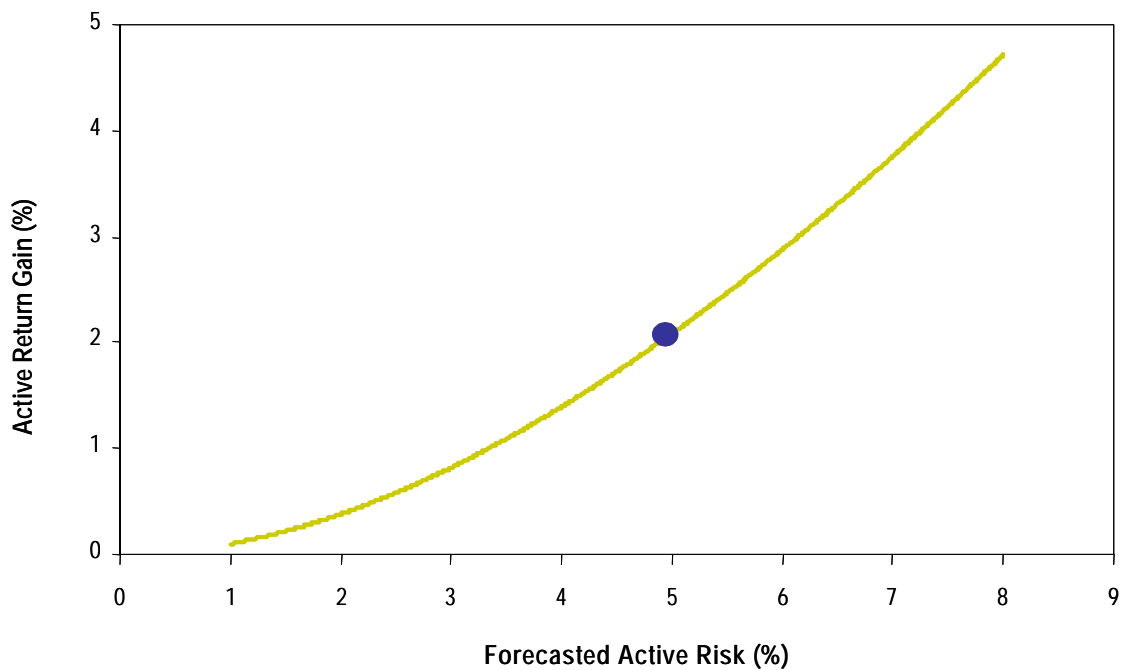
mispricing, overpriced securities should be as interesting to us as the underpriced, which raises the specter of short-selling.

Significant portfolio improvement opportunities increase when the long-only constraint is removed. Relaxing the long-only constraint contributes to portfolio efficiency in two ways:

- It enables the manager to underweight an overvalued security by a margin larger than its weight in the benchmark, and
- For a given amount of capital, it permits larger overweights in underpriced assets.

Figure 1 illustrates the gain in active return for various levels of active risk when the constraint is relaxed. Under the assumptions here, with active risk of 5%, the increase in alpha is more than 200 basis points.

Figure 1



Source: Grinold and Kahn

Thus, *skillful* long-short managers have an edge over long-only managers, all else the same. This is an argument in favor of introducing managers unencumbered by the long-only constraint.

It is important to note that there are limitations, costs, and frictions associated with short selling that can prove severely restrictive for some strategies, revealing once again limits of arbitrage. With time the evolution of markets may lessen them. In this respect, the SEC's proposal to do away with the up-tick rule is a promising sign; and some ECNs, by the way, are already exempt from that rule.

Separating Strategic Allocation and Diversification from Value-Added Investing

Traditionally, alpha has been lost in the shuffle with beta. This is true even of hedge funds, where our research indicates that 44% of diversified hedge fund exposures are directional, and up to 80% of the return variation is market related. In our jargon, beta is being sold as alpha, even among hedge funds.

Increasingly we hear that the ultimate in refining portfolio management is *separating how we get the return of the policy portfolio from how we seek to exploit security mispricing*. One important goal here is to pay passive-management fees for the return of the policy portfolio and active management fees solely for alpha generation. Another goal is to be in a position to select managers with the highest prospective information ratios without regard to asset-class considerations. In principle, here lies the ultimate flexibility in implementing the policy portfolio.

While we hear a great deal about so-called portable-alpha schemes nowadays, they are uncommon in practice and, at best, piecemeal in operation. Implementation remains a big problem. Scraping alphas clean of their associated betas is easier said than done. The technology and instruments to do this remain esoteric for now, and very few funds have the knowledge and resources to manage their portfolios this way. Furthermore, some of the relevant instruments are not amply liquid.

Convention is another hurdle. We are accustomed to thinking in terms of asset classes, in implementation as well as policy design. And the prospect of a derivatives-laden portfolio only serves to raise the hurdle of acceptance for many fiduciaries.

In the interest of accelerating the advancement of the state of our art, I take this opportunity to introduce and advocate a new concept in money management – this is what I refer to as *the master manager*.

To appreciate what follows you will have to let your imagination run a bit. The master manager is a hybrid of indexer, overlay manager, transition manager, master custodian and consultant. Now it doesn't necessarily replace these functions entirely, but it does combine elements of all of them. The master manager is also a not-so-distant cousin of the "new-paradigm" manager Charley Ellis advocated more than a decade ago. *The role of the master manager is to facilitate advanced forms of institutional portfolio management*. This new breed of manager would perform these functions for a pension or endowment fund:

1. **The master manager implements the marketable securities component of the client's policy portfolio using index funds, ETFs, and derivatives as cheaply as possible.** In this respect, the master manager is a macro-passive manager, utilizing all the media available.
2. **The master manager makes cash or securities available from time to time to fund active managers of the client's choosing.** It does this, for example, by using futures to gain exposure to certain market sectors and withdrawing the free cash to fund a new manager. Or it may conduct a transition from a passive portfolio to an active one. For very large funds – those with separate-account index funds – the master manager may be able to lessen the cost of borrowing shares for short sales by lending them directly from passive portfolios.
3. **The master manager monitors risk and compliance of the active portfolios. This is a not uncommon function of master trustees and overlay managers.**
4. **The master manager neutralizes any unintended factor exposures, including leverage.** The client may appoint active managers that are strictly market neutral, leaving as the only factor exposures those of the policy portfolio. In the more likely event that some managers bring factor exposures, such as a stock market beta, a value bias, or unwanted leverage, the master manager is in a position to *adapt* its portfolio to them in the spirit of completeness investing. This is a feature Barton Waring has dubbed “portable beta.”
5. **The master manager rebalances in accordance with the client's direction to preserve the character of the policy portfolio and balance the active risk budget.** In this capacity, the master manager is in a good position to help the client evaluate the trade-off between tracking error and transaction costs.

The master manager requires exceptional capabilities of three types: analytical, trading and operational. It does not, however, employ *skill* in the sense of accurately forecasting security mispricing. Rather, it offers a fully integrated platform for the client to pursue alpha independent of the business of getting the policy portfolio return.

Two challenges face the investor seeking alpha independently of the policy portfolio return. One is *cost*. Alpha-only strategies are priced richer than conventional investment management, with higher base fees plus profit participations. There is also the cost of attempting to separate alpha from beta and maintaining the desired risk exposures, and employing a master manager may involve additional fees. It is important to note that very large funds can internalize the master management function as a way of controlling cost.

A second challenge is *making an accurate assessment of the factor exposures of the active managers*. With traditional long-only portfolios, this may not be a problem. It can be, however, for managers lacking transparency of their holdings.

SUMMARY

The policy portfolio serves a critical function in fund management – it's here to stay. Greater flexibility in implementing the policy portfolio is of interest to those – and only to those – who can select skillful active managers. Broadening mandates and relaxing the long-only constraint are two sensible ways to introduce greater flexibility, although short sellers face constraints of their own. The ultimate flexibility is attained when investors separate altogether the way they get the return of the policy portfolio from the way they seek active returns. Today, this is easier said than done.

For the approach to take hold, I believe we will need to see three developments:

- More large funds developing internally the capabilities required to separate alpha from beta;
- More managers of institutional caliber offering alpha-only strategies; and
- Entrance on the scene of at least a few master managers.