Since the financial crisis many institutional investors have begun to review their asset allocation policies and explore alternative approaches. Regarding equity allocation, investors today are faced with the challenge of defining an opportunity set that spans developed and emerging markets and a range of market capitalizations.

Traditionally institutional investors partitioned the global investment opportunity set into geographic building blocks, commonly with a domestic/international split or with regional blocks. As global equity markets have evolved, institutional investors increasingly are adopting a more integrated global equity investment process. Our research suggests that global equity mandates, together with dedicated emerging market mandates and small-cap mandates, may be emerging as the “new classic” structure for implementing equity allocation. This “new classic” structure is summarized in Figure 1.

The structure shown in Figure 1 encompasses a global mandate for developed-market large- and mid-cap equities, which then are complemented by dedicated emerging market and small-cap specialist mandates. Global equity mandates have the advantage of giving managers a higher degree of freedom in making investment decisions. At the same time, emerging market and small-cap equity segments historically have exhibited return-and-risk traits that differ from those of their counterparts in large- and mid-cap developed markets.

Institutional Trends toward Global Equity Mandates

As shown in Figure 2, U.S. investors typically have implemented equity allocations using U.S. and international mandates, while European investors often have adopted a more fragmented mandate structure. Under this traditional structure, institutional investors select managers within relatively narrow building blocks and allow the manager line-up to reflect the mandate structure. While investors potentially can benefit from their managers’ local/regional expertise, the downside is that managers are limited to their segments and must forgo outside investment opportunities.

With the globalization of equity markets, using the old domestic versus international structure or the structure based on regional blocks makes less sense because the underlying global equity opportunity set is increasingly the same for all investors. For this reason, more and more institutional investors have chosen to adopt a global equity allocation. At the policy level, the investment opportunity set encompasses the global equity universe. Often, the policy allocation is represented by a global equity index, such as the MSCI ACWI Investable Market Index (MSCI ACWI IMI) that covers large-, mid-, and small-cap companies in developed and emerging markets. Global equity mandates have the advantage of giving managers a higher degree of freedom in making investment decisions. For instance, managers can apply sector expertise or...
available to managers and typically is computed as the standard deviation of stock returns at a particular point in time. Figure 4 shows that, while country factors dominated industry factors in the late 1990s, industry factors have become fragmented that global industries now play a very significant role in driving the cross-section of security returns in developed markets. The cross-sectional dispersion of security returns has been a popular way of measuring the opportunity set available to managers and typically is computed as the standard deviation of stock returns at a particular point in time. Figure 4 shows that, while country factors dominated industry factors in the late 1990s, industry factors have become

![Figure 2: Traditional Equity Mandate Structures of U.S. and European Investors](image1)

**Figure 2: Traditional Equity Mandate Structures of U.S. and European Investors**

- **Composition of Institutional Equity Mandates for U.S. Investors**
  - U.S. Equity
  - International Equity
  - Global Equity
  - Emerging Markets Equity
  - Asia Pacific Equity
  - Europe Equity
  - Japan Equity

- **Equity Mandate Structure of Sample European Pension Plan**
  - Domestic Equity
  - Europe Equity
  - North America Equity
  - Asia Pacific Equity
  - Japan Equity
  - Emerging Markets Equity
  - Global Equity

Source: eVestment Alliance, public websites of sample pension funds, MSCI. International equity mandates include the EAFE, EAFE Plus, and ACWI ex U.S. mandates; global equity mandates include the World and ACWI mandates.

**Table 1: Coverage and Composition of the Global Equity Universe**

<table>
<thead>
<tr>
<th>Country Type</th>
<th>Large/Mid Cap</th>
<th>Small Cap</th>
<th>All Cap</th>
<th>Large/Mid Cap</th>
<th>Small Cap</th>
<th>All Cap</th>
</tr>
</thead>
<tbody>
<tr>
<td>Developed Markets:</td>
<td>1,659</td>
<td>4,517</td>
<td>6,176</td>
<td>75.4%</td>
<td>11.4%</td>
<td>86.8%</td>
</tr>
<tr>
<td>MSCI World IMI</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Emerging Markets:</td>
<td>756</td>
<td>1,892</td>
<td>2,648</td>
<td>11.5%</td>
<td>1.7%</td>
<td>13.2%</td>
</tr>
<tr>
<td>MSCI Emerging Markets IMI</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Developed &amp; Emerging:</td>
<td>2,415</td>
<td>6,409</td>
<td>8,824</td>
<td>86.9%</td>
<td>13.1%</td>
<td>100.0%</td>
</tr>
<tr>
<td>MSCI ACWI IMI</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: MSCI. Data as of August 2, 2010.

**Figure 3: Growth in Global Equity Mandate Initial Funding**

![Figure 3: Growth in Global Equity Mandate Initial Funding](image2)

Source: Intersec

**Table 1: Coverage and Composition of the Global Equity Universe**

- **Insight to Select the Best Stocks in Global Sectors, Regardless of the Domicile of the Companies.**

Figure 3 shows the strong increase in the initial funding of global equity mandates: From a mere 6 percent in 2000, it grew to represent 38 percent of all global and international equity initial funding in 2009.

The trend toward global mandates mostly has targeted a broad universe encompassing developed- and emerging-markets mid and large caps (MSCI ACWI). However, some investors have given even broader mandates targeting the whole global equity universe including small caps (MSCI ACWI IMI). Table 1 shows that the full global equity universe (measured by MSCI ACWI IMI) includes more than 8,000 securities across developed and emerging markets and all-cap segments.

**Developed Market Equities as an Integrated Block**

Proponents of a global investment process argue that developed market equities should be managed using global mandates. The global nature of economies and companies increasingly requires managers to value companies versus their peers globally and to identify the best investment opportunities on a global basis. In addition, it is well-docu-
equal or even more important drivers of developed-market stock returns than country factors over the past decade. So-called style factors that capture the behavior of stocks with high/low momentum, volatility, size, and value characteristics also have been important sources of return and risk.

Traditional domestic/international and regional mandates cannot effectively accommodate global industry and style exposure targets. For instance, allocating investments across a number of regional mandates may make it difficult for plan sponsors to implement strategic sector positions. The aggregated sector weights of the global portfolio may become unintended byproducts of the often “bottom-up” investment processes of individual regional mandates. In contrast, global mandates enable plan sponsors and managers to implement and monitor strategic or tactical positions in global sectors and styles more effectively.

The higher degree of freedom for managers to pick stocks globally and manage global sector and style exposures offers more potential to add value. Figure 5 shows that the top-quartile active global managers (benchmarked to the MSCI World Index) have indeed outperformed the top-quartile U.S. and EAFE managers over the past five and 10 years.

Though institutional investors seem to agree that the large/mid-cap segment of developed market equities may be managed globally, there is less consensus as to whether global mandates also should cover emerging markets and small caps. In the next two sections, we look more closely at these two segments.

### Allocating to Emerging Market Equities

Institutional investors generally use two different approaches to introduce emerging market exposures. The first is through broad international or global mandates that include emerging markets (such as ACWI excluding U.S. or ACWI mandates). The second is through dedicated emerging market mandates. Some investors prefer dedicated emerging market mandates as a way to implement

#### FIGURE 4: RISK-AND-RETURN DRIVERS IN DEVELOPED MARKETS

Contribution of Risk Factors to Explained Cross Sectional Volatility (CSV)

![Graph showing contribution of risk factors to explained cross-sectional volatility](image)

Source: MSCI. Shown above is the contribution to cross-sectional volatility of returns. For each stock, the return attributable to country, industry, and style factors defined in the Barra Global Equity Model are computed. The variance of the component-level returns is then calculated at each point in time across all stocks in the MSCI World Index. The percentage of the total variance explained by each type of factor is shown.

#### FIGURE 5: HISTORICAL PERFORMANCE OF TOP-QUARTILE U.S., EAFE, AND WORLD MANDATES

<table>
<thead>
<tr>
<th>Top-Quartile Excess Return of Active Managers</th>
<th>Top-Quartile Information Ratio of Active Managers</th>
</tr>
</thead>
<tbody>
<tr>
<td><img src="image" alt="Bar chart showing 5-year and 10-year performance" /></td>
<td><img src="image" alt="Bar chart showing 5-year and 10-year performance" /></td>
</tr>
</tbody>
</table>

Source: MSCI, eVestment Alliance. Data as of March 2010. The performance analysis is before adjustments for selection bias, survival bias, and management fees. Excess return is the active return relative to the benchmark. EAFE stands for Europe, Australasia, and Far East, i.e., all developed markets excluding the United States and Canada of the MSCI World country coverage. Past performance is not indicative of future results.

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a certain level of strategic exposure to this segment; for instance, a strategic overweight in emerging markets. In contrast, the emerging market exposure in international and global mandates may vary across different managers and over time.

Most emerging markets differ from developed markets in level of economic development and market accessibility. Not surprisingly, many investors consider emerging markets to have risk-and-return drivers that are different from those in developed markets. Local factors such as economic, political, and regulatory risks are often dominant drivers in emerging market equities. This suggests that emerging markets require a different investment process and, correspondingly, investors may attach special value to emerging market managers’ specialization and track record.

Figure 6 confirms that country factors in emerging markets are still more important return drivers than industry and style factors. This is in contrast to developed markets, in which global industry and style factors dominate. This suggests that country allocation and local expertise may be more important skills for managing emerging market mandates. In addition, relative to developed markets, systematic factors are a bigger driver of return, indicating that a top-down investment process may be more relevant for emerging markets.

The importance of a top-down investment process with a focus on country allocation implies that emerging market managers may have more potential to add value in a global emerging market mandate, as opposed to regional/country emerging market mandates. Table 2 shows that the vast majority of emerging market mandates (94.5 percent by assets under management) are defined globally as opposed to regionally. Table 2 also shows that emerging market mandates typically target core exposures instead of value/growth styles, which is consistent with the finding that style factors play a less important role in emerging markets. In addition, note that all-cap mandates already represent 14.3 percent of emerging market mandates. This is a recent development and indication that investors may be opting for all-cap mandates to get deeper exposure to emerging markets.

Allocating to Small-Cap Equities

Similar to emerging market equities, a lack of consensus remains among institutional investors as to whether global mandates should cover small-cap equities. While there is a deep pool of U.S. small-cap products, the number of international, global, and emerging market small-cap products is limited. Investors typically have implemented a small-cap allocation in one of two ways: through the all-cap mandate or specialist small-cap mandates. In table 2, small-cap products represent only 0.6 percent of emerging market mandates.

In developed markets, however, there is a much deeper pool of specialist small-cap managers. Like emerging market mandates, specialist small-cap mandates often are considered a way to introduce a more systematic exposure to the small-cap segment. Investors who prefer specialist small-cap mandates typically point to the differences between small caps and large/mid caps. For instance, the small-cap segment often is considered less efficient due to relatively poor information flow compared to large caps. The relatively illiquid nature of small-cap stocks also makes capacity constraints an important consideration.

Table 2: Characteristics of Emerging Market Mandates

<table>
<thead>
<tr>
<th>Composition of Emerging Market Mandates</th>
<th>% by AUM</th>
</tr>
</thead>
<tbody>
<tr>
<td>Geographic Region</td>
<td></td>
</tr>
<tr>
<td>Diversified Emerging Markets</td>
<td>94.5%</td>
</tr>
<tr>
<td>Regional/Country</td>
<td>5.5%</td>
</tr>
<tr>
<td>Primary Style</td>
<td></td>
</tr>
<tr>
<td>Core</td>
<td>87.5%</td>
</tr>
<tr>
<td>Value</td>
<td>7.3%</td>
</tr>
<tr>
<td>Growth</td>
<td>5.2%</td>
</tr>
<tr>
<td>Capitalization</td>
<td></td>
</tr>
<tr>
<td>Large/Mid Cap</td>
<td>85.1%</td>
</tr>
<tr>
<td>All Cap</td>
<td>14.3%</td>
</tr>
<tr>
<td>Small Cap</td>
<td>0.6%</td>
</tr>
</tbody>
</table>
Finally, because of the higher return dispersion of small-cap managers, there is a greater degree of manager selection risk than in the large/mid-cap segment.

The risk-and-return drivers of small caps are more heavily affected by company-specific characteristics than they are for large caps. Figure 7 shows that systematic factors explain a smaller proportion of the cross-sectional volatility in small-cap stocks compared to both large/mid-cap stocks (represented by the MSCI World Index) and emerging markets (represented by the MSCI Emerging Markets Index). This suggests that a bottom-up stock-picking investment process may be more important for actively managed small-cap portfolios than for the other segments.

Due to the higher company-specific risks and the more local nature of small-cap companies, investors may opt for regional mandates to benefit from a manager’s stock-picking skills and local knowledge. Indeed, some investors consider global small cap to be a relatively difficult mandate to execute successfully, given the challenge for a manager to possess a significant amount of local company-specific knowledge spread across countries and regions.

Given the company-specific drivers of small caps, the performance dispersion of individual small-cap managers has been higher than for large-cap managers. This represents both a challenge and an opportunity for plan sponsors that aim to select top managers. Because the small-cap universe contains thousands of relatively small stocks with high company-specific risks, individual small-cap managers can hold portfolios of different risk profiles, which can result in higher manager-return dispersion. Figure 8A shows that a smaller proportion of small-cap managers (relative to large/mid-cap managers) delivered performance similar to the median peer. Moreover, the risk of choosing a manager that significantly underperformed was historically greater for small caps: About 19 percent of small-cap managers underperformed the median peer by more than 3 percent, while merely 5 percent of large/mid-cap managers delivered such underperformance.

Small-cap managers also have tended to incur higher tracking errors. In figure 8B, the tracking error distribution of U.S. small-cap managers is significantly skewed to the right (i.e., higher tracking error) compared to U.S. large/mid-cap managers.

The higher tracking error and return dispersion of small-cap managers imply...
One approach that often is used by pension plans to diversify the manager selection risk is to adopt multiple mandates in each market segment.

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Kang, Xiaowei, Frank Nielsen, and Giacomo Fachinotti. 2010. MSCI Research Insight (October).

Endnotes
1. This article is based on a previous longer version titled “The ‘New Classic’ Equity Allocation?” by Kang et al. (2010).
2. A similar practice is observed in Japan, where most of the equity mandates traditionally have been structured along domestic and non-domestic portfolios.
3. eVestment Alliance provides a database that covers a global sample of investment products, including more than 6,000 equity products.
4. EAFE stands for Europe, Australasia, and Far East, i.e., all developed markets excluding the United States and Canada of the MSCI World country coverage.
5. Aylur Subramanian et al. (2009), Kang and Melas (2010), and Chia (2009) discuss the inherent risks of home-biased equity allocation in institutional portfolios and the increasing adoption of a global approach to equity allocation.
6. Note that because the growth in the initial funding of global equity mandates is a relatively recent trend, global equity mandates still represent a smaller proportion of total institutional equity assets compared to international mandates (see figure 1).
8. During certain periods of high systematic market risk (i.e., around the 2001 bubble and the recent financial crisis), style factors became so dominant that they explained about 40–60 percent of the cross-sectional stock return dispersion.
9. Plan sponsors are able to set explicit sector and style policies on global mandates, in addition to regional exposure guidelines.