Managing Outside the Box

BY ROBERT A. JAEGER, Ph.D.

The investment business is a business of fads and fashions. One of the most conspicuous current fashions is the growing interest in loosening traditional investment constraints. This interest drives the current fascination with hedge funds and with long-only managers who are not totally obsessed with the standard benchmarks.

In theory, the investment management business should be a business that rewards independent judgment, creativity, and courage. In practice, the investment management business all too often turns into a bureaucratic straightjacket in which clients and consultants obsess about the minutiae of performance measurement: benchmarks, tracking error, information ratios, style drift, and so forth. It is not surprising that many money managers have emigrated from the long-only world to the world of hedge funds, which offer the possibility of an intoxicating combination of greater freedom and higher fees. The irony, of course, is that the hedge fund world now has its own panoply of indexes, style boxes, and consultants who worry about “style drift.”

The desire to evade the tyranny of the benchmarks is very healthy, if it’s implemented properly. The key to success is to have realistic expectations, thus avoiding the classic problem of throwing over one fad in order to be swept away by another.

Benchmarks and Bull Markets
Once upon a time, the job of an equity manager was to deliver a real return over inflation when measured over longer-term holding periods. There was a general realization that the ups and downs of “the market” were an important influence on results, but managers used a fairly broad range of tools in pursuit of their objective, and there was no single dominant measure of “the market.” For example, managers sometimes raised cash, either as the result of a top-down market judgment or because their bottom-up investment process did not deliver enough stocks to buy. In addition, some managers were willing to adjust their sector exposures quite actively, either in response to top-down judgments, bottom-up processes, or some combination of the two. Those of us who were in the consulting business in the late 1970s and early 1980s remember a varied and colorful landscape of money managers.

What happened? Three things: the institutionalization of the business; an 18-year bull market; and the growing hegemony of the index fund. “Institutionalization” covers a multitude of phenomena all related to the shift away from balanced managers who offered one-stop shopping toward portfolios of multiple specialists. Building these portfolios became the specialty of the various consulting firms that canvassed the universe for talented specialists to blend into a diversified portfolio. Consultants needed style boxes, each with its appropriate benchmark. Thus emerged the machinery of tracking error, style drift, information ratios, and other devices whose primary function was to make sure that managers stayed in their assigned boxes.

The second aggravating factor was a powerful bull market that reigned from 1982 to 2000 with only minor interruptions. In this environment, money managers who held cash were likely to lag the market. Managers therefore were under strong pressure to remain fully invested at all times, which meant equitizing any available cash, an operation that became quite simple thanks to the development of the stock index futures market.

The third factor was the growing popularity of index funds and the growing difficulty of beating the indexes. This phenomenon became especially acute during the last stages of the bull market, when the market’s gains were increasingly concentrated in a small number of mega-cap
names that many active managers regarded as prohibitively overvalued.

Although passive management had various academic arguments in its favor, the ultimate argument was the performance argument. Passive management worked. However, it worked not because it was bound to work but because a unique bull market made it work. The defining feature of a bull market is that making money is easy: Indexing is the ideal bull market strategy. Consider the stark difference between the United States and Japan, where investors faced a combination of low interest rates and weak equity markets for most of the 1990s and early 2000s. In that Japanese environment, active management (including even a strong interest in hedge funds) became a necessity.

Herb Stein, chairman of the Council of Economic Advisers under President Richard Nixon, used to say that if something can’t go on forever, it won’t. Although the U.S. bull market lasted longer than most people expected, it did eventually end. As the indexes declined, interest in active management exploded. “Active management” here includes both “absolute-return strategies” (hedge funds and so forth) and new tools for beating old benchmarks.

**Old Wine in New Bottles**

As institutional investors explore this brave new world, it is crucial to separate two ways of “cutting loose.” On the one hand, there are investors mainly interested in finding new strategies for beating the traditional benchmarks. This is the “new wine in old bottles” approach. On the other hand, there are investors striving to build portfolios that are not so dependent on the traditional benchmarks. This is the “new bottle” approach.

The most prominent example of “new wine in old bottles” is portable alpha: yoking a multimanager hedge fund portfolio to a derivatives hedge in order to create a synthetic equity portfolio or synthetic bond portfolio. More recently, we have seen the emergence of the 130/30 portfolio, in which an equity manager will be 130-percent long and 30-percent short, thus remaining 100-percent long at all times. This approach avoids the major predicament of the long-only index-oriented manager, who must cope with indexes that typically are very unbalanced, combining a small number of large positions with a large number of small positions. In the S&P 500, for example, there are 455 stocks that each account for less than 0.5 percent of the index. These stocks collectively account for 53.4 percent of the total index capitalization. (These figures are based on data as of September 30, 2006.) Even if a manager hates a stock with a 0.5-percent weight, the most that he/she can do is to be 0.5-percent underweight. In the 130/30 format, there is more room for expressing a negative opinion.

Both portable alpha and 130/30 have the potential to deliver meaningful alpha over a benchmark. Portable alpha has particular relevance for bond portfolios, which have drawn increased attention as investors have become more focused on liability-driven investing. The bond universe is a highly competitive universe in which benchmarks are hard to beat and the performance spread between the first and third quartiles often is measured in basis points, not percentage points. This makes it appealing to use equity-oriented strategies as the source of alpha and then transport the alpha over into the fixed income universe.

In many situations the alpha source is a fund-of-funds portfolio, combining the talents of many hedge fund managers representing a well-diversified set of hedge fund strategies. This is a perfectly feasible strategy. Indeed, my own firm has been managing such portfolios for more than 15 years. However, the hedge fund universe offers its own unique set of challenges, especially in the current environment. There are more than 10,000 hedge funds, but not all of them have a competitive edge that will enable them to capture the elusive alpha. Moreover, some (but not all) strategies show signs of overcrowding. In other words, strategy allocation and manager selection are critical. Part of the challenge is to maintain the right balance between excessive optimism (long-only management is dead; hedge funds are the only way to generate alpha) and excessive pessimism (there’s too much money in hedge funds; the game is over).¹

The essential point about portable alpha, 130/30, and the other new strategies is that they all are examples of active management and thus are subject to all the vicissitudes thereof. I am a firm believer in active management, but I believe even more firmly in realistic expectations. Many institutions, disappointed by the performance of their long-only active managers, are competing to identify “the new new thing” that will enable them to replace their long-only managers with something more state-of-the-art. This may be an unfortunate example of the greener grass syndrome: the deep-seated conviction that the strategy that you haven’t tried yet will work much better than the strategies that you have tried. The governing reality here is that genuine investment skill is rare throughout the investment world, even in the neighborhood of hedge funds and 130/30 strategies.

**New Bottles**

The preceding examples all fall under the general heading of new wine in old bottles or new strategies for beating old benchmarks. How about new bottles: portfolios that are not so benchmark-driven? Old-fashioned equity management, which is not focused on minimizing tracking error, is a prime example. Hedge funds are another good example. Notice, however, that in these cases benchmarks are not completely absent. Rather, the benchmark is some positive number,
perhaps related to inflation, or a short-term interest rate. (Notice that liability-driven investing is not an absolute-return approach. If the benchmark is the return on a client-specific stream of liabilities, then that benchmark will be negative in a rising rate environment.)

This point applies even, and perhaps especially, to those institutions that have been most innovative and opportunistic in thinking about their broad asset allocation posture. When university endowments make substantial allocations to hedge funds, timberland, private equity, and so forth, they do so because they want the total portfolio to generate an attractive absolute return. Similarly, when institutions hire global asset allocators to adjust the overall asset mix of the portfolio, their highly opportunistic approach is designed partly to avoid (or at least mitigate) the pain that inevitably comes from static asset mixes. The flight from 60/40 is driven by the conviction that positive returns are more important than beating a benchmark that may easily wind up in negative territory. (To be sure, even the more exotic alternatives-heavy portfolios can be viewed as being driven by market forces that have the potential to produce negative returns. But those forces are different from those that drive the standard 60/40 portfolio.)

This more opportunistic approach to investment management recalls some of Peter Bernstein’s recent observations about policy portfolios. Bernstein’s basic argument is that flexibility and opportunism are the only appropriate responses to a world that is intrinsically uncertain and volatile. I agree, but, as always, it is important not to get carried away. In this business, those who get carried away often wind up getting carried out.

Two Kinds of Style Drift
For those who believe in constrained active management, style drift is the ultimate sin. But style drift can be either good or bad. Good style drift is a sensible response to changing circumstances. Bad style drift is aimless wandering, what the British call “losing the plot.” Good style drift is healthy evolution, while bad style drift is unhealthy tampering, often driven by unrealistic expectations. Bernstein’s plea for flexibility and opportunism can be seen as a plea for the right kind of style drift, both at the level of individual managers and at the level of the fiduciaries who employ those managers. Needless to say, the distinction between the two kinds of style drift presupposes that there is some notion of prudence or skill that does not boil down to staying in your box.

What is the verdict on this new interest in loosening constraints? Is it good or bad? On the whole, I would say that it is good, since it is clear that hyperconstrained money management is a dead end. But flexibility and opportunism are double-edged swords: They can be used well or used badly. As Spiderman reminds us, with great power comes great responsibility. And responsibility is a matter of good judgment, not low tracking error.

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Endnotes