

PLACE YOUR BETS

Analyzing the relative merits of market risk and active risk.



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THE CASE FOR ACTIVE MANAGEMENT THEREFORE NEEDS TO BE BASED ON TWO BELIEFS.

The investment risk taken by pension funds can be broadly split into market risk (i.e., from investing in equities) and active risk. For almost all pension funds, market risk swamps active risk. What are the relative merits of these two types of risk?

MARKET VERSUS ACTIVE RISK

We would intuitively expect equities to offer higher returns than bonds over the long-term in order to compensate investors for the greater uncertainty of returns. Conversely, there is no such rationale for active risk to be rewarded, and active management is a zero-sum game.

The case for active management therefore needs to be based on two beliefs. Firstly, that there are skillful managers that can add value over the long-term and secondly, that the pension fund has the ability to pick these managers. While there are a number of conceptual reasons why pension funds may have an advantage in accessing alpha, the decision on whether to employ active management depends on the subjective views of the trustees and their advisors. However, if skillful managers can be selected, then active risk offers tremendous diversification benefits.

Typically, the average pension fund has a tracking error of approximately 11% relative to a bond-based liability benchmark, with active risk accounting for less than a tenth of this risk. In order for this current split of risk to be optimal then the expected net information ratio from active management would be 0.06. Given an average active risk of 1%, this implies an expected alpha of 12 basis points—far lower than actual expectations.

One of the key reasons for the low level of active risk is that it is diversified through employing a number of active managers. Another explanation for the low level of

active risk relates to behavioural biases. As active risk relies more on the pension plan's ability to pick managers, it is a natural reaction to be prudent with the level of active risk taken and reduce the scope for regret. This behavioural bias would have been exacerbated by the bull market of the '80s and '90s as market risk was well rewarded and the more genuinely active managers were in danger of being left behind. There was clearly an element of survival of the safest during this period.

So to sum up this debate, we do not offer a view on whether pension funds should employ active managers. However, if the pension plan believes in active management, then the expected risk-return trade-off would be enhanced by taking more active risk and/or less market risk.

In order to do this, the fund may need to look at gearing alpha through market-neutral strategies. As this is still an unconventional approach the potential for regret is high, and hence strong conviction is needed to go down this route.

One development that could help in the move to more genuine active management is the growing importance of unconstrained or absolute return mandates with a longer term horizon and less focus on indices or peer groups. This thinking is typified by an innovative competition run by a consortium of international pension funds headed by the U.K.'s Universities Superannuation Scheme and consultants Hewitt Bacon and Woodrow. The competition was an open request for proposals on how to structure and manage a large mandate with a 20-year investment horizon. The results of this competition should make interesting reading.

While there are a number of grey areas regarding the structure and risk/return objectives of such mandates, this idea will likely take hold and we will see some mandates being awarded on this basis in the near future. ■