

Fidelity  Investments

Risk Management Conference

What Style is your International Equity Portfolio?

August 23, 2002

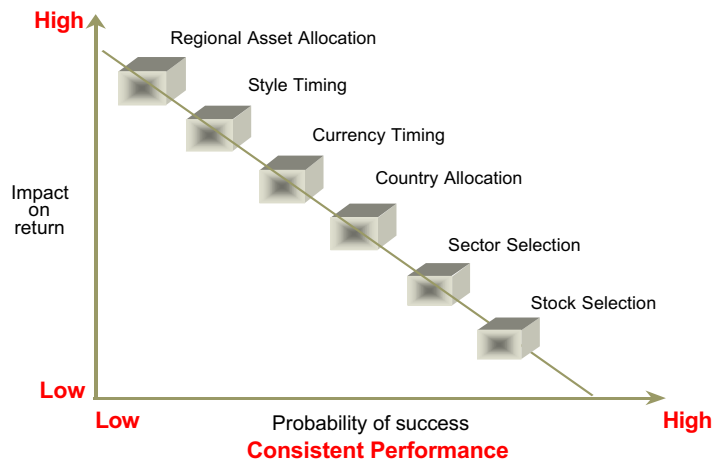
Ravi Mantha, CFA
Portfolio Manager, International Equities
Fidelity Management & Research

What is Style?

- ◆ Style is essentially any manager bias that causes significant non-systematic risk in the portfolio versus the benchmark.
- ◆ Often, this bias is also the chief source of the manager's strength—for instance, a manager that has a great small cap research team.
- ◆ The good news is that you can pick a group of complementary specialist managers, which diversify away the non-systematic risk at the plan level.
- ◆ It is the plan sponsor's responsibility to minimize total risk at the plan level, with the assistance of their consultant.
- ◆ In order to do this, it is essential to understand the key sources of risk in a portfolio.

"Risk comes from not knowing what you are doing"
– Warren Buffett

Sources of Risk in a Portfolio



Style Comes From Many Sources...

Typical examples of style:

- ◆ A manager who favors small capitalization stocks
- ◆ A manager who uses a Price/Earnings screen to eliminate “expensive” stocks
- ◆ A firm that has a house Dividend Discount model
- ◆ A manager that has a “strategic” under/overweight in a region
- ◆ “We only have 20% annual portfolio turnover, since our time horizon is longer than everyone else”
- ◆ “Our investment committee is made up of individuals who strongly believe in our price momentum philosophy”

How Do You Minimize Style Risk?

- ◆ The size of your international equity portfolio often determines the approach (and the number of managers).
- ◆ Smaller plans are probably better off hiring a single, Core manager.
- ◆ Hire specialist managers, and neutralize their benchmark risk at the plan level (the multi-manager approach).
- ◆ No active combination will give you perfect style neutrality. Know your appetite for style risk.
- ◆ Be proactive. If there is a huge style bias at the plan level, fix it before it blows up.

Key Question: Is Your Manager Still Doing What You Hired Them to Do?



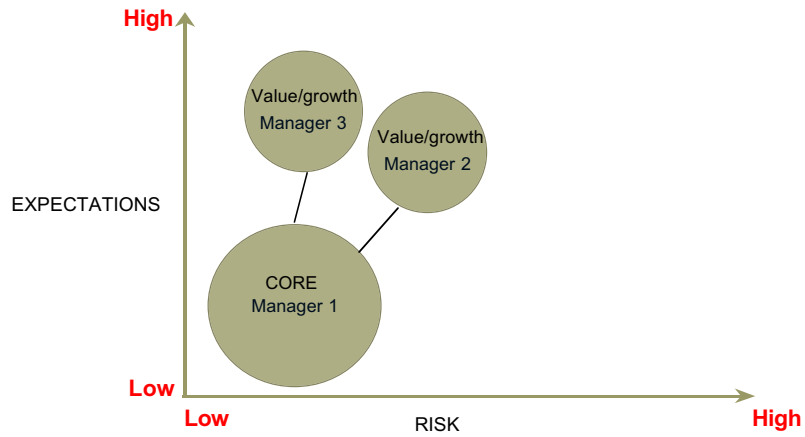
Ways of Building a Portfolio

- The Cap Weighted Regional Approach



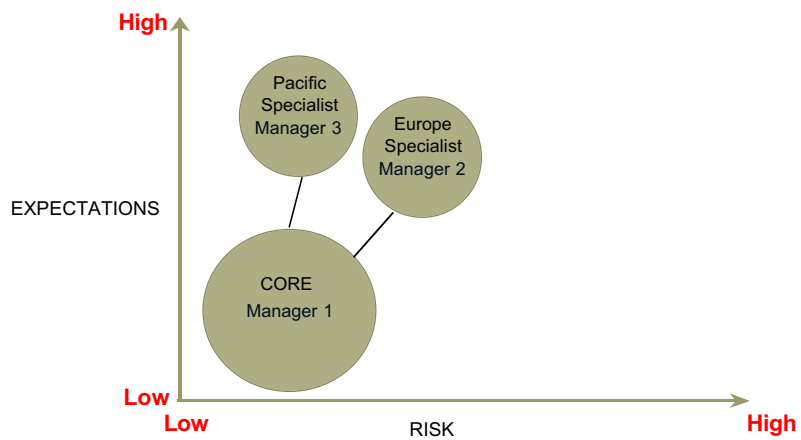
Ways of Building a Portfolio

- The Core and Satellite Approach

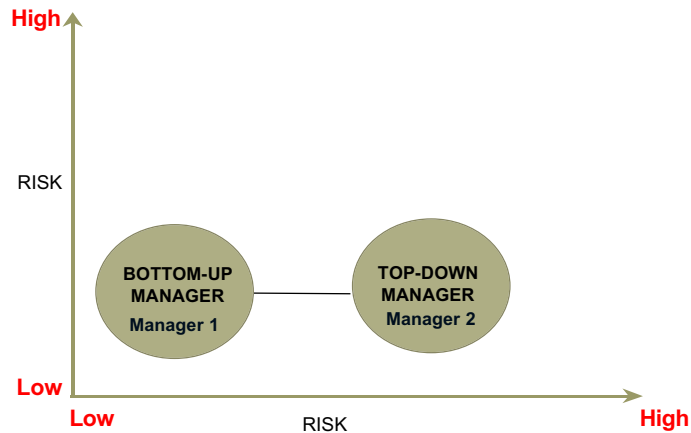


Ways of Building a Portfolio

- The Core and Satellite Approach



One Way That Has Fallen Out of Favor...



Because Top-Down Strategies Are Risky...

- ◆ “In December 2000, a panel of economists at major investment banks on average predicted US GDP of 3% for 2001, with a range between 2% (HSBC) to 4.1% (ANN-AMRO). The actual number was 1.2%.”

Source: *The Economist*

- ◆ Economic analysis is ineffective even at predicting the magnitude of economic growth.
- ◆ Stock market is a **leading** indicator of economic growth. That makes the hurdle rate for top-down managers very high indeed.

There Is a Role for Absolute Return Strategies in Large Plans. But If the Bogey Is Your Benchmark, Top-down Strategies Are Risky.

Characteristics of a Core Manager

- ◆ A global research organization
- ◆ Bottom-up stock picker
- ◆ Eliminates unintended bets from the portfolio
- ◆ Does not have a house model
- ◆ Does not employ screening techniques
- ◆ Is close to style-neutral
- ◆ Has a high **expected** information ratio
- ◆ Tracks the benchmark closely, but delivers consistent value throughout the market cycle

Characteristics of a “Satellite” Manager

- ◆ A readily apparent core competitive advantage—they are the best in the world at something
- ◆ Relentless focus on their core advantage—regardless of the market cycle
- ◆ Bottom-up stock picker
- ◆ A long, successful track record, punctuated by bouts of underperformance (when their style is out of favor)
- ◆ A high tracking error

**And Hire These Managers Just After
They’ve Had a Bad Year...**

