VALUE, COUNTRY BY COUNTRY

Differences in valuation by region can offer investors a 'free lunch' of sorts.

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Plan sponsors have a number of new opportunities for enhancing return: exploiting the 'free lunch' of cross-border valuation anomalies; cutting managers free from benchmarks; and finally, to exploit more persistent alpha opportunities offered in less-efficient markets, independent of the underlying market exposure.

Perhaps the last free lunch left in global equity markets is the inefficiency of cross-border valuations. The structure of Wall Street clearly lags that of Main Street. With so much money managed relative to local market indices, and Wall Street incentivizing analysts based on their Institutional Investor (II) rankings, it is no surprise that many valuations are driven by local—not global—factors. The high observable 'home bias' of plans is clear evidence of sub-optional allocation of capital. Business managers have advanced much further, recognising that industries have globalised. Nearly all major trading partners have seen their correlation of GDP increase over recent years (except Japan); in the same way, investment opportunities are now global. Exxon does not consider Wal-Mart to be a competitor, yet U.S. portfolio managers make that comparison every day. Surely Exxon is best compared with Total or Royal Dutch, and investment capital should be allocated accordingly. With Total at almost half the valuation of Exxon—yet growing at twice the pace—the choice is an easy one, yet it is not available to many portfolio managers.

It follows therefore that consideration should be given to appointing global—not international—managers, able to exploit the widest opportunity set of ideas. This trend towards global mandates is likely to grow. However, one of the key impediments remains the dominant weight of the U.S. in the MSCI index, analogous to Japan in 1989. If managers are to be benchmarked globally, they should be given freedom to *not* invest on the basis of market capitalisation.

One of the most expensive questions ever asked is, "What is the weighting of Nortel in the index?" Tight adherence to benchmarks has not served plans well over recent years and demands further examination. Encouraging managers to deliver their best ideas over the long term will ensure a much greater focus on the real risks inherent in investment, rather than the current focus on relative risk. Benchmarks have provided an easy shorthand to measure a manager's skill, but at a price: a better way may be to encourage managers into a 'horse-race' against their peers, ensuring a higher proportion of active risk in portfolios, but without necessarily increasing the absolute risk of the portfolio.

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This mismatch between relative and absolute risk has got the industry into a muddle. We need to better distinguish between market (beta) risk and active (alpha) risk. Beta generally swamps alpha risk: for those who believe they can be successful in selecting managers, the mix is almost certainly wrong. Not all asset classes provide equal opportunities—witness the huge outperformance of EAFE managers relative to their index, and the tiny dispersion of returns of the bond managers in their attempts to beat their index. Beta risk has proved extremely difficult to predict—virtually nobody predicted that the emerging market countries would be the worst performers of the 1990s, yet many of the trends in alpha generation have shown more persistence. Plans should increasingly be more cognizant of how they allocate their risk budget between alpha and beta, remembering the Holy Grail is fifteen or so genuinely independent sources of return. The trend towards portable alpha products has a long way to run, as managers with multiple alpha sources seek to package those independently of the underlying beta exposure. ▮