OPPORTUNITIES WITHOUT BORDERS

Once you've recognized a global opportunity, how should you seize it?

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In a world where returns are likely to remain modest compared to the exuberance of the 1980s and 1990s, plan sponsors are increasingly seeking more alpha from their active managers. This has led to a proliferation of portfolio approaches designed to capture alpha with extended opportunity sets and alternative investment approaches, as well as a quest to identify the perfect environment for growing alpha which has opened the door to portfolios unconstrained by artificial restrictions. To better understand this environment and how investors are responding to it, we focus on three topics:

- The relationship between low levels of volatility and the ability of active mangers to generate alpha;
- How European plan sponsors have responded to bridging the "returns gap," and;
- The spectrum of unconventional and unconstrained portfolio structures available.

We first observe that the current "low" levels of volatility witnessed in EAFE markets are not far from long-run historic norms over the period 1970 to 2005. Indeed, "low" volatility through this period is not exceptional, with episodic spikes of volatility normally being associated with sharply falling markets. Similarly, we could find no relationship between the ability of active managers to beat the EAFE benchmark during periods of heightened volatility, nor could we find evidence of a widening of the interquartile spread of returns across active managers, either coincident with, or lagging, periods of increased volatility. We therefore dismiss the lament of some active managers and many hedge fund managers that the absence of volatility is inhibiting their success.

RESEARCH FROM EUROPE

In 2004 we surveyed nearly 200 European-based institutions with some $1.7 trillion of assets to discover their perspective on how best to bridge the "returns gap." Despite current low levels of exposure to hedge funds and alternative asset classes, we observed a growing interest in tactical asset allocation approaches (perhaps reflecting disenchantment with static policy portfolio benchmarks) and a willingness to embrace "benchmark-free" and absolute return long-only portfolio structures, as well as an array of hedge funds. There appeared to be little interest in either "alpha-porting" approaches or leveraging either bond or equity portfolios.

In the last section, we moved to a focus on implementation. We examined three approaches to benchmark-free portfolio management:

- Highly diversified equally weighted portfolios with sector and country neutrality;
- Benchmark-free "best ideas" portfolios measured against other managers hired to run identical mandates, and;
- A structured approach consisting of a highly concentrated portfolio with market risk controlled through futures and options overlays.

Each approach provides a different set of benefits and risks to plan sponsors, and all are reflective of a growing willingness to move away from the constraints of cap-weighted benchmark-driven portfolios. In this world, the relationship between plan sponsors and asset managers becomes more collaborative, as outcomes are driven more by manager skill and less by benchmark return. Measures of success are therefore more broadly defined than simply pinning a benchmark to a wall and throwing portfolio "darts" at the target. Success is triangulated against expected outcomes across a variety of possible market measures.

OUT WITH CONVENTION

In conclusion, it seems evident that successful execution in this environment will most likely require adoption of an unconstrained portfolio approach. It is likely that the global search for alpha will continue, principally exploiting the less efficiently priced equity markets. We believe that this world of low numbers and high expectations demands a rethinking of conventional structures. ■