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Total Return: An Overlooked Style

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As the world integrates, the real opportunity to diversify is through style.

Although total return investing helps pension plans exceed their actuarial liabilities, it is an overlooked investment style. The investor's objective should be to get to point "b" from point "a", not beat the index. However, plan sponsors tend to stick to tested investment styles in order to fulfill their fiduciary duty, control rogue managers, and monitor the investment process.

These reasons have merit but they create problems related to index obsession and index style purity. The focus remains on the index despite the attractiveness of other investment options. With index style purity there is an underlying danger of performance being affected by market volatility. Total return investing involves the addition of another layer of investments to the typical pension asset grid for equity investing that sits over top of the traditional asset allocation framework.

Index Obsession

A basic equity allocation grid with broad choices in size, style and region does little to define the appropriateness of an investment. Most are built on past performance with little adjustment for potential downside performance and minor adjustments for risk. For example, Japan was the world's largest stock market due to excessive valuation versus peers with no bias to value or growth. In hindsight, it became one of the greatest under-weighting opportunities in history. Since 1989, Japan has plummeted from 37 per cent to 8 per cent of global market capitalization. The United States, on the other hand, has risen from 32 per cent to 56 per cent. Will the situation repeat itself? It certainly could.

In the U.S., issues with accounting and the credibility and stability of earnings have led to a revisiting of earnings assumptions. The relative differences between the U.S. and the rest of the world have declined.

Of more interest is the issue of valuation. Should investors be paying 20 times each dollar earned on

NASDAQ versus cheaper valuations in Asia?

These developments present interesting opportunities for the total return manager.

Investment Style Purity

The second issue is that of style overwhelming geographic diversification. As the world integrates and its financial markets and currencies form broader blocs, the real diversification opportunity is through style. The ability to move across growth and value should help to protect against style shifts in the market. Again, the objective is for returns to beat actuarial liabilities. But asset allocation shifts are difficult: shifts can be rapid and results extremely start-and-end-date sensitive.

An alternative is an overlay strategy, probably in the form of an alpha-capturing strategy focused on absolute returns over relative returns. Well-documented issues relate to fund size and alpha capture and transparency, but they are becoming easier to monitor. Also, execution and management costs remain high.

Dynamic rebalancing allows for retention of the current investment process, although execution is difficult. The time frame is likely shorter than traditional policy shifts and that can be disruptive, especially for deep value situations and small capitalization stocks.

Total return management involves an overlay of a dynamically managed fund dealing with the entire cube. The challenge is to manage the fund to create a buffer zone to the asset grid.

The total return manager is typically a stock picker rather than a macro momentum investor, using various screens for security selection. They are style-agnostic, willing to move around in search of the best opportunities. Variables sought in the present environment include low P/E multiples, low debt/equity ratios, reasonable growth, high yield, and a discount to Net Asset Values.

Portfolio construction doesn't look like the index, with variances across the portfolio. The ideal manager will exhibit a track record of stability in performance in both growth and value markets. ■