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Investments

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A Global Overview
Why delivering lower risk is smarter than promising past returns

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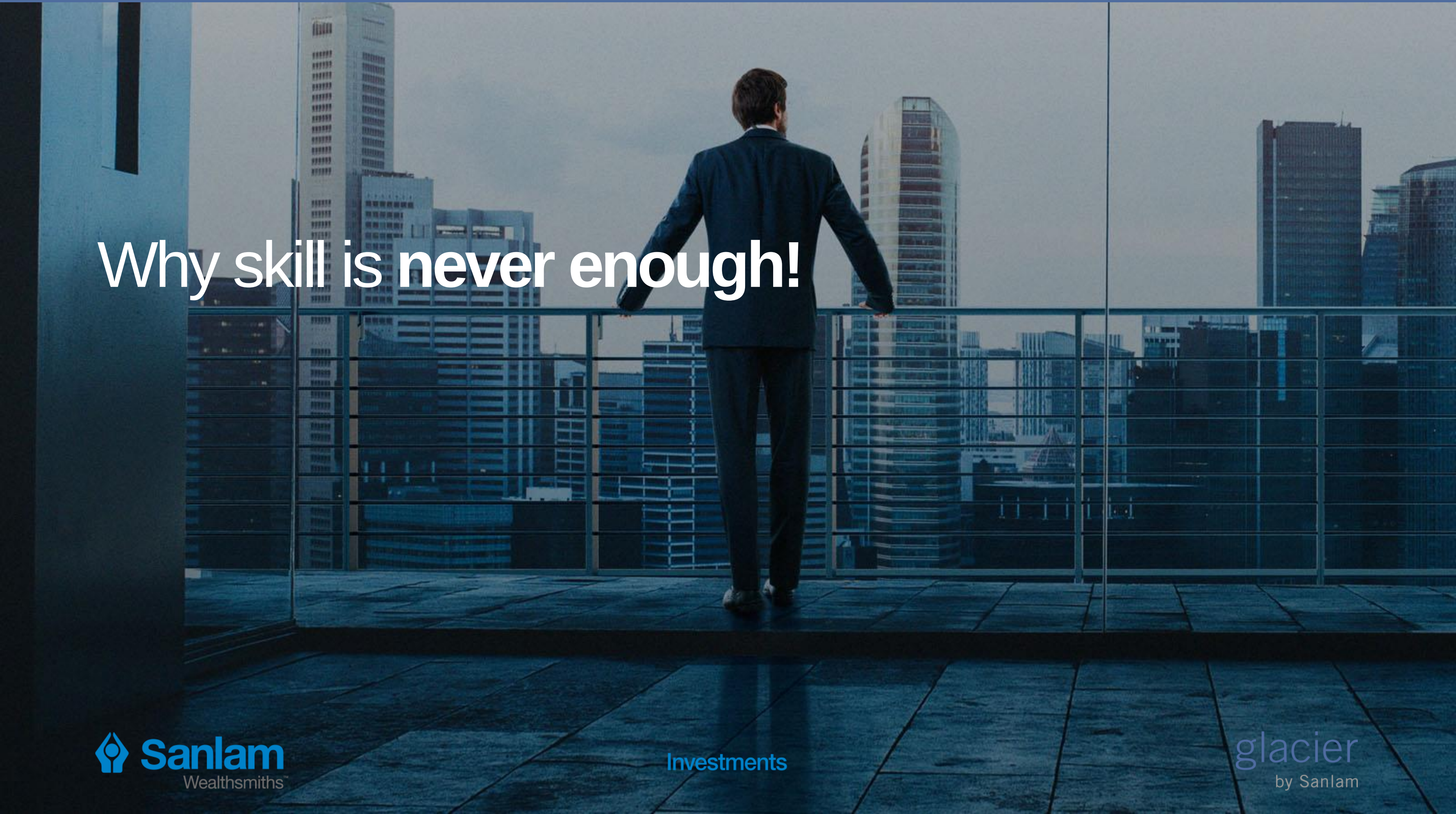
Why delivering lower risk is smarter than promising past returns

1. Why skill is never enough!
2. Why neither active nor passive investing can save us
3. The strange future of asset management

Why skill is **never enough!**



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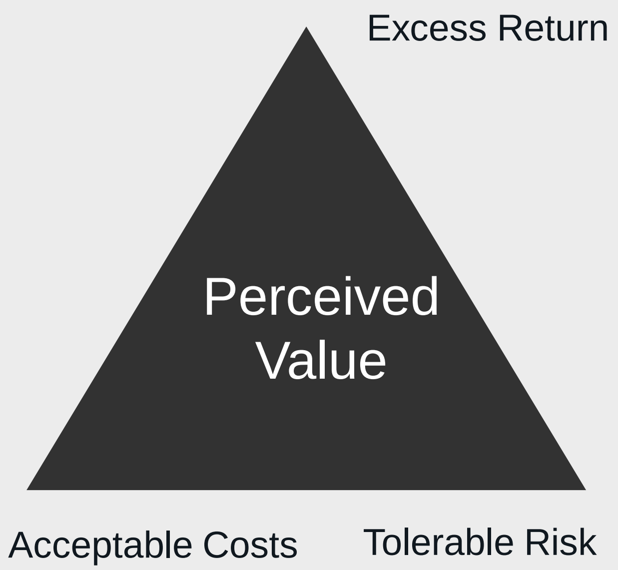
What do investors **really, really need?**

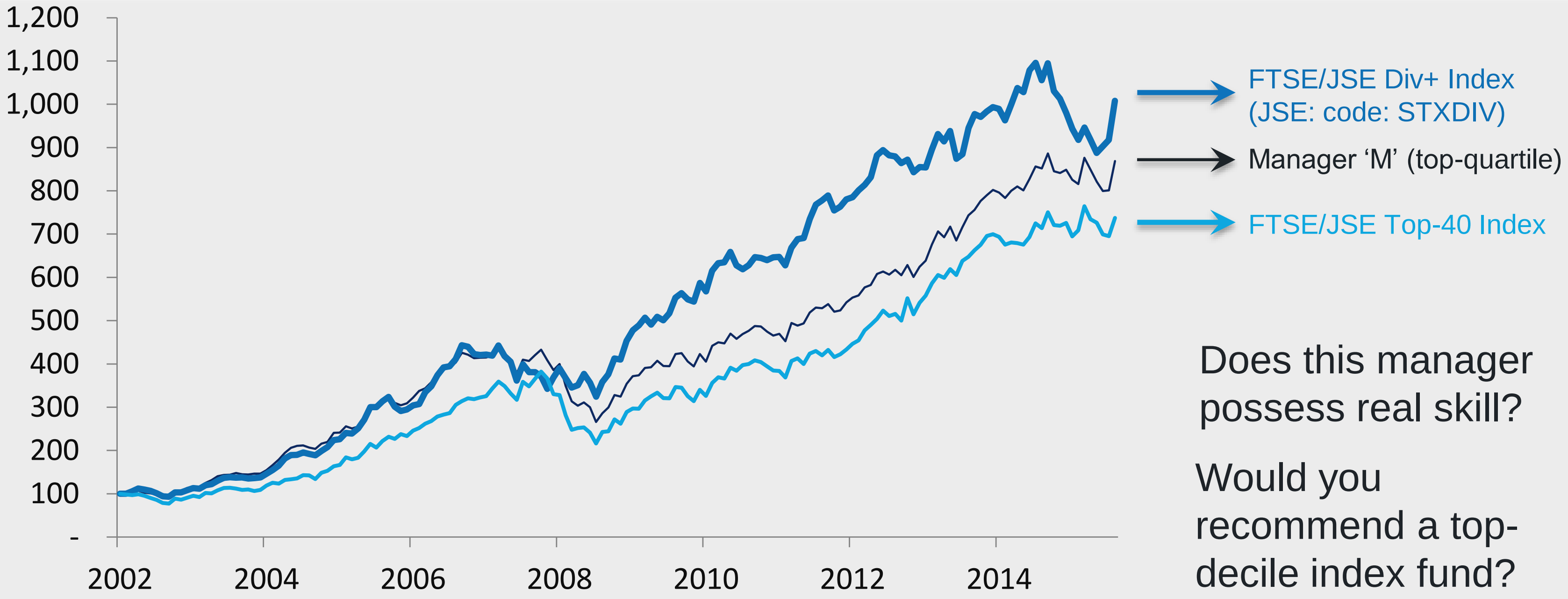
- ‘Excess’ return (e.g. above inflation, benchmark, liabilities etc.)
- Positive return after all costs
- Return without excessive ‘risk’



Key question:

How necessary is skill?

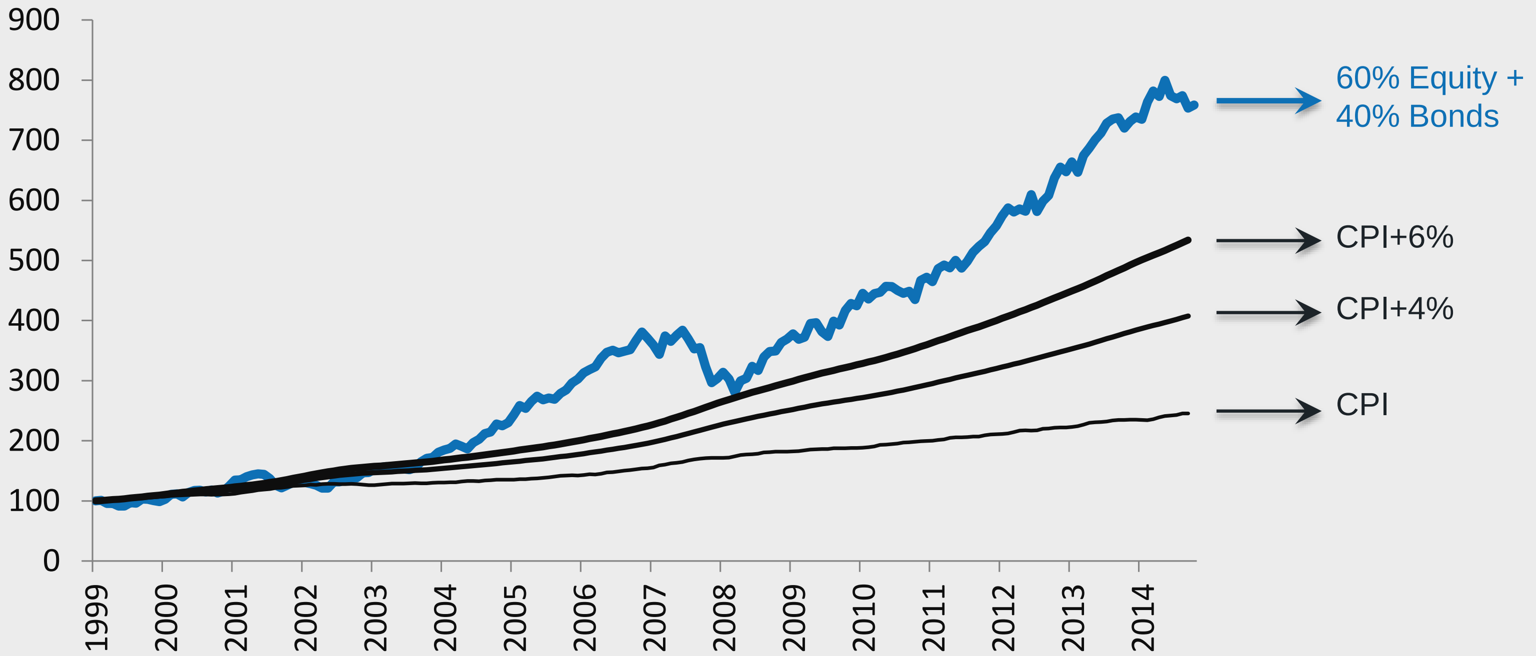
How important is skill (beating benchmarks)?



Does this manager possess real skill?

Would you recommend a top-decile index fund?

How important is skill (beating benchmarks)?



Never confuse **excess return with skill**

- Why do we invest in equities?
- Risk premia are not a free lunch!
- Excess returns exist regardless of skill

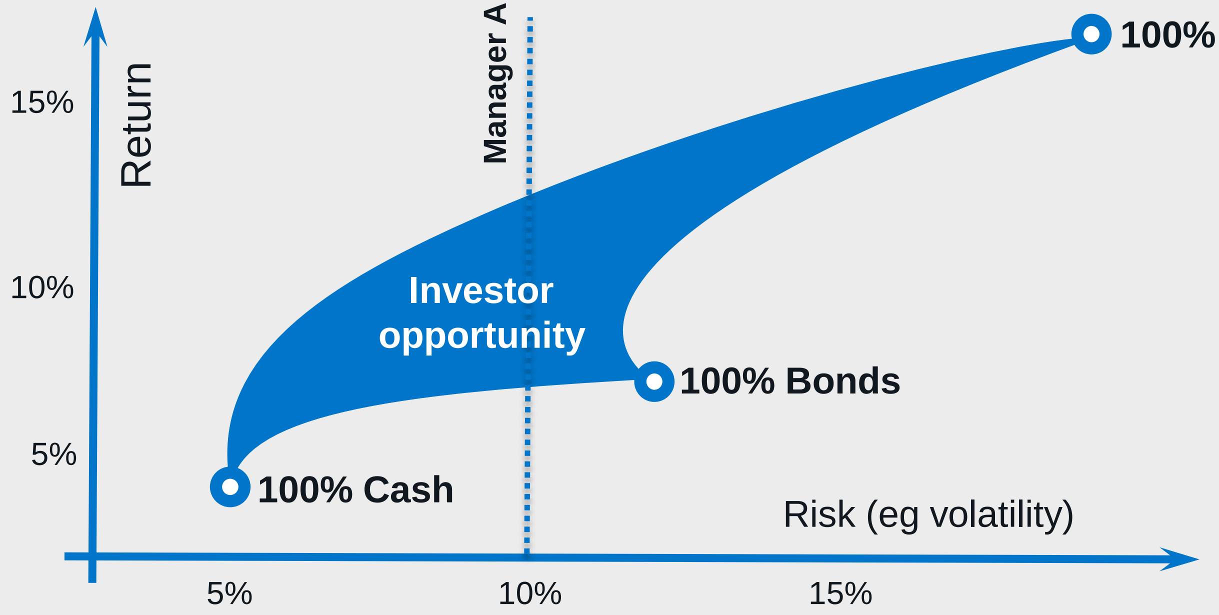
Never confuse **excess return with skill**

How can we beat these benchmarks without skill?

Benchmark Return: **50% Equity + 50% Bonds**	Benchmark Return: **JSE ALSI, FTSE 100, S&P500**	Benchmark Return: **MSCI World Index**

Chasing past performance doesn't work, because we inevitably chase higher risk, rather than true skill.

Risk matching – a big step in the right direction



Manager return has to be judged in comparison to level of portfolio risk

Proper risk-adjusted performance (Jensen α) is global standard but not in SA!

Is skill attributable to ‘**excess risk**’?

Maybe what we’re calling skill really isn’t skill. It may turn out that skill can be partially decomposed into what have come to be called the Fama/French risk factors – the small-cap premium, the value-growth spread, the momentum effect, etc. Discussion may turn to how the excess returns, now attributed to skill, are actually coming from such factors.

Harindra de Silva
CFA Magazine Journal (Sept-Oct 2006)

Why neither active nor passive investing can save us

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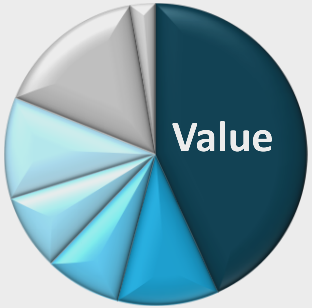
Problem with **active and passive management**

Option 1: Active Management

Manager Selection

Unstable Risk Exposure

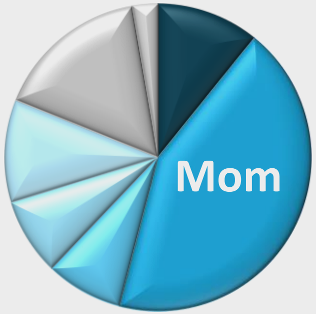
- *Manager F*
- *Manager I*
- *Manager C*
- *Manager A*



Option 2: Passive Management

Unstable Risk Exposure

Passive Market Index



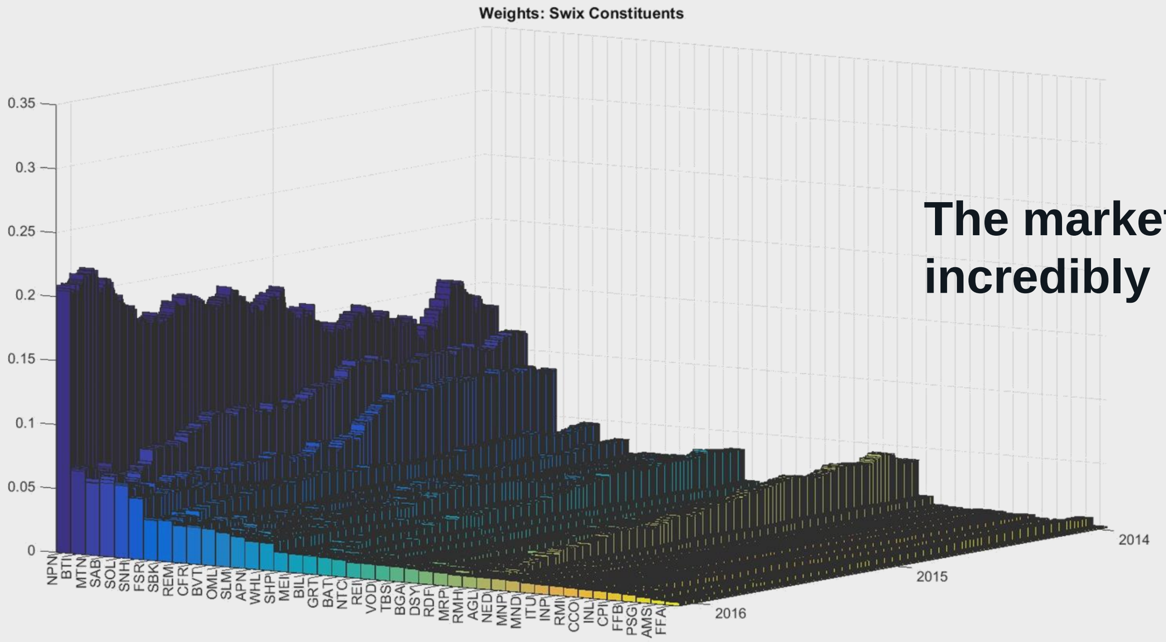
Neither active nor passive investing are properly diversified

Active managers are **poorly diversified**

FUND	RISK FACTORS	ADJ. R^2	MARKET BETA	ALPHA
PORTFOLIO	Rand Hedge; Low Beta	93.20%	0.87***	0.001
M1	Rand Hedge; Low Beta	88.75%	0.90***	0.002*
M2	Rand Hedge; Low Beta	89.43%	0.87***	0.003**
M3	Rand Hedge; Value	88.77%	0.81***	0.002*
M4	Rand Hedge; Value	90.53%	0.89***	0.001
M5	Rand Hedge; Low Beta	90.63%	0.90***	-0.0003
M6	Rand Hedge; Low Beta	80.97%	0.74***	0.004***

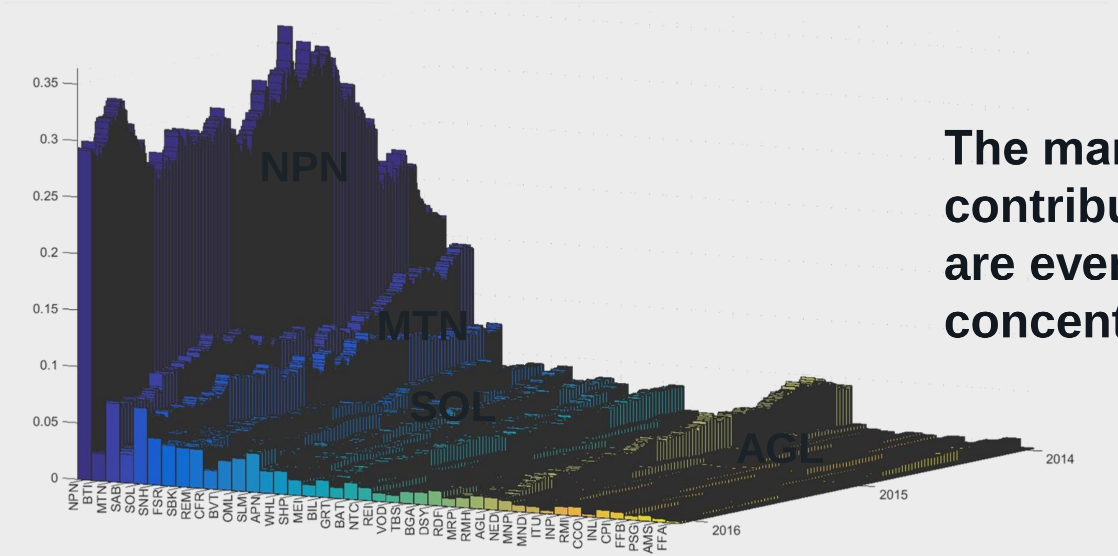
Source: Department of Finance – WITS

Market indices are also **poorly diversified**



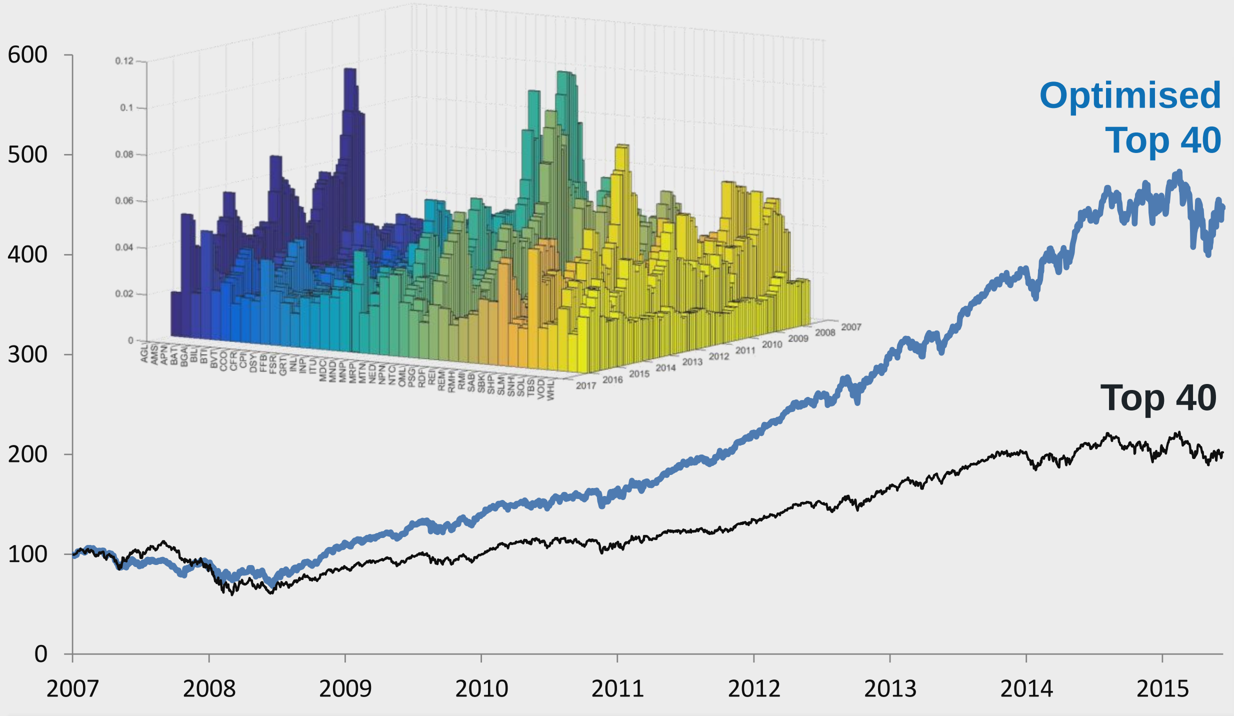
The market index is incredibly undiversified

Stocks’ risk contributions



The market’s risk contributions are even more concentrated

How to **improve risk structure** of the market



Find the weights for Top 40 stocks with ‘maximum diversification’

Step 1: ensure ‘good’ risks (ie risk premia) are always present

Step 2: minimise concentration

The strange future of asset management

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Four forces disrupting investment management

Force 1: Benchmarking revolution

Why excess returns tell us nothing about skill. We need proper-risk adjusted returns

Force 2: Index revolution

Why hiring and firing indices is smarter to manage risk than hiring and firing managers

Force 3: Portfolio-construction revolution

Only modular portfolios can adapt to changing market conditions quickly and efficiently

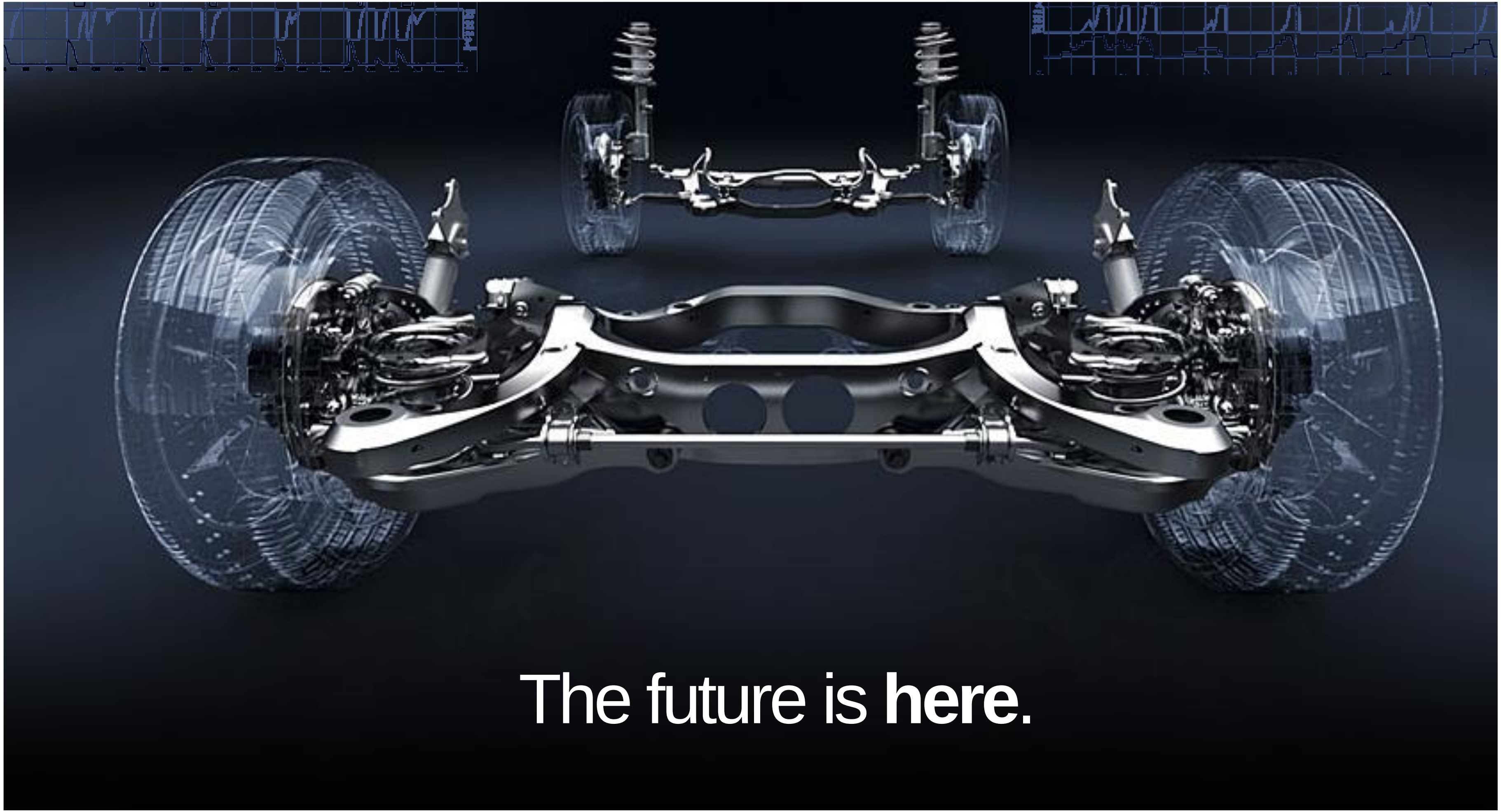
Force 4: Risk management revolution

Promising past returns does not work but we can lower risk and the cost of investing

Conclusion: We need to improve active and passive investments

Active Funds need more than just 'Value' risk exposure	Passive Funds need more than just 'Momentum' risk exposure
Active Funds must reduce their high correlation to the market	Passive Funds must reduce their extreme stock concentration

- **Challenge:** Neither active/passive funds are able to adapt to changing market conditions efficiently (eg high vs low volatility regimes)


The future is **here.**

Thank you

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