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Managers seek a more reliable approach

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After the past two years, discussions of risk suddenly seem much less abstract. The way in which apparently diverse markets took a synchronised dive last year has shaken up ideas about diversification.

The greatest concern is that diversification itself did not work the way investors' models had supposed. Classically, asset allocation involves making trade-offs between different asset classes. This tends to be labelled the "60/40" approach, because many institutions tend to start with 60 per cent in equities and 40 per cent in bonds.

In the past 10 years, these models have become much more sophisticated, as investors add new asset classes that appear to have a low correlation with equities or bonds. Most prominently, this has involved diving into commodities and currency trading. But it has also been popular to try out esoteric strategies used by hedge funds, that were designed not to correlate with the market, as well as highly illiquid investments in forestry or energy. Last year this approach came catastrophically unstuck, as virtually all of these asset classes fell in unison. This was a disaster for institutional fund managers.

"The correlation between supposedly uncorrelated assets was higher in the up market and much higher during the down market than they had been led to believe," says Amin Rajan, of CREATE Research of in Kent, southern England, who said that many institutions wanted to follow the trail blazed successfully by big endowments such as that of Yale University. "These models hadn't been stress-tested. They went into it on the principle that these opportunities existed, and there was a first-mover advantage. But they had no governance structures and no skill sets to manage those risky assets."

Asset allocation previously proceeded on the assumption that correlations between different asset classes were relatively stable over time. One implication of the crash is, therefore, likely to be that the alternative asset classes, such as commodities, that gained favour because they appeared to have a low correlation with stocks and bonds could now lose popularity.

"Instead of a stable matrix, there are probably multiple states of the world," says Jeremy Siegel, finance professor at the University of Pennsylvania's Wharton School. "We are seeing negative correlations that have turned positive, and that wreaks havoc. It could be very damaging for alternative asset class enthusiasts, because positively correlated asset classes don't have anything like the same attraction."

Mohamed El-Erian, head of the large bond management group Pimco, suggests that asset allocation should be about the "risk factors" of different investments, rather than about asset classes. "The same risk factor can apply in different asset classes," he says. For example, there is an equity risk factor in corporate bonds. "What makes this interesting is that it's not just about the classic factors like equity, or default, or interest rates, or inflation or liquidity. There's also a risk factor, which is public policy. Whether we like it or not, government has become an integral part of markets."

A similar idea, of "alternative risk budgeting", comes from Wells Fargo, a company that was in the forefront of developing modern portfolio theory a generation ago.

All look at the risk of outright loss, rather than the volatility of returns.

This requires asset allocators to look at nine different kinds of risk: concentration risk (the risk that many investors have crowded into the same strategy, making it more prone to sudden busts); leverage risk (which multiplies both gains and losses); liquidity risk (the chance that an asset cannot be sold quickly at the prevailing price); transparency risk (if the investment structure is too complex to understand, Wells Fargo suggests, it is too risky); sensitivity to the overall equity market, and bond market; event risk (the danger an unforeseen event could pose); volatility risk (the extent to which returns vary); and operational risk, which includes various risks of businesses failing to perform.

Other changes are afoot. The steady shift towards passive investing (merely attempting to replicate a benchmark, rather than to beat it, and saving on expenses) is likely to stay intact.

There will also be a change in the way brokers analyse retail mutual funds, and the way pension consultants analyse institutions. Over the past 10 years the "style box" approach has predominated. This has typically involved splitting funds into nine separate categories, according to whether they used the growth or value style or a combination of the two, and whether they invested in small-, mid- or large-cap stocks. Fund managers would be given a mandate to keep to a very precise style, and were expected to maintain it even when market conditions for it looked bad.

This is being replaced by intensive efforts to find ways to reveal which fund managers have skill, and then to give the truly gifted managers greater autonomy. Rather than "closet indexing" - staying close to a benchmark - the idea is that assets should be truly passive, or entrusted to managers with skill.

"When you've been through a market like the one we've been through, the implications of style boxes and paying for relative performance suddenly don't feel that good," says Dennis Alff, a portfolio manager with Vaughan Nelson Investment Management. He points out that the achievement of a small-cap value manager in beating his benchmark by 1 per cent does not look so appealing if the benchmark is down by 30 per cent. "You'll see a move away from the practice of constraining managers and towards absolute returns, as opposed to relative nonsense."

Investors will also be more conservative, particularly when it comes to leverage. Clifford Asness, founder of AQR, says: "For the foreseeable future, I think people will be much more sensitive about getting into a leveraged trade. While leverage will still be a useful tool, all-else-equal, the smarter investor will always prefer the less leveraged trade, and more so going forward."