## INTRODUCTION

# INNOVATION MEANS TRADITIONAL MODEL NO LONGER FITS

The increasing use of ETFs, structured products and evolving commodities themes has led to a blurring of the boundary between core investments and their satellite assets. Elizabeth Cripps reports

Once upon a time, core satellite strategies were easy to understand. They combined a substantial core allocation to low risk passive funds, with a satellite of riskier, but potentially more lucrative, actively managed assets.

Now, things are so much more complicated that Roger Noddings, chief investment officer at HSBC Global Asset Management in the UK, is cautious about using the term "core satellite" at all. "It means a lot of different things to different people," he warns.

For a start, it is no longer always possible to talk in clear cut terms of active or passive management. On the face of it, things might seem straightforward. As Rob Drijkoningen, head of ING Investment Management's multi asset group, puts it: "The terms beta and alpha are often mentioned in respect to the separation between passive and active portfolio management. On one side there are passive management houses offering a wide range of index tracking products (beta) and on the other side of the spectrum there are asset managers and hedge funds offering to deliver alpha."

But, according to Marie-Pierre Sapin Knox, head of institutional balanced management at Société Générale Asset Management, "a mix between passive and active is becoming more accepted. You can use passive products for an active strategy – diversification, sector bets or country bets. You don't need active products for active bets."

The active-passive distinction itself is up for debate. But what does that mean for those high net worth individuals (HNWIs) who once adopted an uncomplicated indexed core, active satellite approach to their portfolios?

### THE RISE OF ETFS

Increasingly, they are turning to exchange traded funds (ETFs). But, to complicate matters yet again, ETFs themselves can offer a range of variants on what was once a core satellite approach.

**"MOST ETFS ENJOY A GOOD LIQUIDITY AND CAN BE EASILY TRADED IN THE MARKET, THEREFORE EXECUTION RISK IS MINIMAL"**

**ROB DRIJKONINGEN, ING**

For a start, they can be used in the so-called passive core of a portfolio. Traditionally, the purpose of this component would be to seek beta through index tracking products. Nowadays, according to Mr Drijkoningen, "an investor can choose from a wide variety of instruments if they are looking for beta exposure to a certain asset class". ETFs, he adds, "are one way to gain market exposure and can certainly fulfil this purpose.

There are a number of advantages to using ETFs in this way. According to Reza Vishkai, head of alternatives at Insight Investment, "for the core indices they actually track very well and at incredibly low cost. It depends what market you are operating in but in some markets there are also taxation advantages to using ETFs."

Mr Drijkoningen agrees that ETFs are "relatively cheap

and flexible to use". He adds that prices are easily accessible, since the funds are listed, and the funds are very transparent, because holding information is generally readily available. "Most ETFs enjoy a good liquidity and can be easily traded in the market, therefore execution risk is minimal."

That is not to say that they are perfect. Mr Drijkoningen warns that investors need to give careful thought to "what constitutes beta and whether the ETF involved does cover that definition." This, he explains, varies depending on the investment profile.

"One needs to define a strategy horizon and an acceptable tracking error, while taking into account the cost aspect. ETFs are easy to acquire exposure to an index for a short to mid term holding period. For longer holding periods it could be cheaper and more efficient using structured derivatives solutions, for instances fully funded notes or certificates."

The main risk of investing in an ETF lies in the tracking error to the benchmark, according to Mr Drijkoningen. However, he adds: "Even this risk is reducing as over time the sophistication has increased substantially and passive fund management has become an art form."

ETFs are not just for replacing traditional passive products. They can also play an important role in tactical asset allocation. HSBC's Mr Noddings explains: "Strategies for HNW clients have become more aggressive in terms of asset allocation than they were in the past. You need to employ some strategies that allow you to execute that, and ETFs are perfect. They allow you to sell or buy equities effectively and you don't have to touch the core of your portfolio."

Gavin Rankin, head of products and services consulting in the UK for UBS, agrees that ETFs can be used to express tactical asset allocation views, but stresses that UBS only sees them, in this light, as a short term solution.

"Over the past year, we have used ETFs for up to about 50 per cent of our equity allocation within the core, primarily because active managers have been punished, so we have moved more to ETFs as a short term response to market conditions, rather than a long term view," he says.

Indeed, according to SocGen's Ms Sapin Knox, there is a more general tendency for ETFs to take on the role traditionally played by the active satellite component.

"We use index funds, or ETFs, for the core, but more and more we use ETFs for the satellite as well," she says. "They are quite specialised. We see more and more on commodities, for example, and we tend to use them as they are quite liquid, with easy access, and reasonably cheap."

Mr Noddings agrees that ETFs are becoming increasingly innovative. "Financial engineers can build interesting strategies into ETFs. You can have a carry trade ETF, for example. You can buy ETFs in gold, which we have done. ETFs now cover a broad range of opportunities, enabling you to be active in asset allocation and to own things that maybe in the past you wouldn't have dreamed of allowing in a private client's portfolio."

**"WE WOULD LOOK AT THE CORE AS THOSE INVESTMENTS WHICH GENERATE ABSOLUTE RETURNS, SUCH AS HEDGE FUNDS. AS A SATELLITE, WE WOULD THEN HAVE THE MORE OPPORTUNISTIC INVESTMENTS, SUCH AS GOLD"**

**ROGER NODDINGS, JPMORGAN**

## SOPHISTICATED SATELLITES

As well as demonstrating growing appetite for ETFs, wealthy investors are showing themselves willing to experiment with more esoteric products or asset classes in what would have been the "satellite" of their portfolio.

In particular, according to Mr Rankin, "structured products are being used more to express satellite themes". He explains: "They are powerful in changing a return profile for clients. As thematic opportunities tend to be longer term – say 18 months to two years to play out – a lot of factors can change. Structured products can be quite a useful tool for changing the payoff profile over that time horizon."

Such products can also be used to protect investors from inflation – a central theme at the moment, according to Mr Rankin. "For example, we are offering a structured product with inflation protected capital over the time horizon of the trade. With a typical structured product, in the worst case, you get your capital back plus RPI. We are trying to be a bit more inventive."

Two further key satellite themes, he suggests, are commodities and more advanced emerging markets

plays. There has, he explains, been a recent "evolution in commodity themes", with a shift away from standard gold and oil plays to second generation themes, such as companies involved in agribusiness. Similarly, investors are looking to use the satellite component of their portfolio to tap into "the continued impact of emerging market growth, including second generation ideas, not just vanilla BRIC (Brazil, Russia, India and China) ideas".

## ABSOLUTE RETURN CORE

Going further still, some HNWIs are inclined to abandon the notion of a traditionally passive (i.e. index-tracking) core altogether, in favour of an absolute return centre for their portfolio. In the process, they are turning the standard core satellite model inside out.

"Most wealth managers are more focused on capital preservation than capital growth," says Mr Rankin. "We keep people wealthy rather than make them wealthy. With that background, most investors are absolute return focused, which means a cash benchmark."

"It is increasingly common to look at absolute returns," agrees Mr Noddings. "So then we would look at the core as those investments which generate absolute returns, such as hedge funds. As a satellite, we would then have the more opportunistic investments, such as gold."

Insight's Reza Vishkai agrees. "If you look at more sophisticated models of private banking and the portfolios they offer, you see they are generally running the whole thing with a view to absolute returns," he says. "The main objective for most private wealth portfolios is to have something generating consistently high real rates of return.

"It makes a huge amount of sense for a private client to think about it in terms of absolute return because what, ultimately, are they after? They want steady returns and steady growth from their portfolio. But that doesn't mean everything you do is absolute returns orientated."

Thus, he suggests that wealth managers and private banks are often trying to replicate the success of the US endowment foundation market when it comes to structuring portfolios. "This is done by very high allocation to alternatives including private equity, hedge funds, timber land, and at same time still having an equity allocation. So a successful portfolio is going to have a combination of these investments."

In other words, it makes sense to combine a core strong allocation to absolute return products with a strong allocation to beta, gained through equities. But, as Mr Drijkoningen makes clear, such an understanding of core satellite takes us a very long way from the traditional model.

"The passive core has a long exposure position and the absolute return approach does not necessarily. It starts off from a market neutral point and tries to achieve gains by looking for long and short opportunities. Absolute return products also focus on relative strategies between assets without taking a bet on the direction of the market. In other words, the passive core profile is pure beta and the absolute return approach is pure alpha."

**"THE MAIN OBJECTIVE FOR MOST PRIVATE WEALTH PORTFOLIOS IS TO HAVE SOMETHING GENERATING CONSISTENTLY HIGH REAL RATES OF RETURN"**

**REZA VISHKAI, INSIGHT INVESTMENT**

Where, then, does this leave the idea of a core satellite strategy, as any sort of coherent notion? Mr Rankin of UBS takes a stab at summarising the overall trend: "Increasingly, there has been a move towards taking a core and satellite approach to portfolio management, and towards using thematic opportunities which can be put into the satellite bucket."

Naturally, he acknowledges, allocations will differ according to investor tastes. However, he suggests, as "a rough rule of thumb, a 70 per cent allocation to the client's asset allocation, which could be relative or absolute return, and then a 30 per cent allocation to put in thematic opportunities or maybe individual manager plays, where we think that there are good opportunities for a manager or a strategy".

So, something of the original idea remains. Part of a client's portfolio is kept relatively safe, the rest is used to exploit opportunities, as and when they arise.

But, crucially, what counts as "safe" is itself up for discussion – and on that hinges the whole question of what count as core and what as satellite investments. Perhaps, after all, it would be better to eschew talk of cores and satellites altogether, and say only, with Mr Noddings, that "innovation marches on".