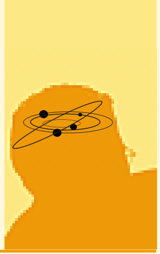

CORE/SATELLITE MODELS

ETFS BREATHE NEW LIFE INTO CORE/SATELLITE INVESTING

While the recent move into a core/satellite approach by the French government may have sparked somewhat of a resurgence of interest in the area, the main reason is the wide adaptation of exchange traded funds. ETFs make asset allocation switches cheap and easy to make with a direct impact on risk management

The strategy of investing in a core portfolio, enhanced by satellite positions in high alpha and high beta assets, has been around for decades. However, a move by the French government to manage part of its state pension fund via a core/satellite approach has sparked new interest.

The portion of France's state pension fund that is using core/satellite is known as the buffer. This is a reserve fund that can be used to bolster the main portfolio.

This fund holds some 60 per cent to 70 per cent in a mix of passive funds linked to various indices, replicating a global index. The satellite plays are of varying risk levels and are invariably invested in uncorrelated assets.

Within traditional models using long-only, active fund managers, the funds tend to have higher levels of risk and tracking error, but offer the possibility of outperformance of the market. But people are often not fully aware of the amount of downside risks they take in these active funds.

RISK AND REWARDS

This is actually part of an old argument – passive versus active and the risks and rewards they offer. The central theme in this debate is that passive investing is a cheap way of accessing the market and, by tracking it, provides investors with exposure but limited risk.

The active side of the debate argues that true stock pickers can add value to a portfolio by picking stocks across the market. By moving away from the index, investors stand a greater chance of outperforming the market. The downside is that returns could also be substantially lower than the given benchmark and the cost of the vehicles is often higher.

This is where core/satellite is gaining ground. By combining the two methodologies it provides a compromise to the argument and overall can still provide a lower level of risk to the end investor.

As the core/satellite approach leads to a high degree of diversity it is also spurring greater divergence in the actual asset management industry, with some groups focusing solely on beta, guaranteeing a benchmark will be respected and the core portfolio will endure. Others are becoming alpha specialists, which intermediaries and multi-managers can choose between on the basis of their ability to outperform the market.

'As the core/satellite approach leads to a high degree of diversity it is also spurring greater divergence in the actual asset management industry'

Bruce Lavine,
Barclays Global Investors

Core/satellite approaches have been a common strategy used by fund managers themselves in which they build the fund using a core of liquid blue chips, which tend to be lower risk than their smaller counterparts. Fund managers are quite often willing to hold a core position in large-caps and make plays with smaller holdings and sometimes even unquoted stocks, to provide a better risk/return profile on the fund. On one hand, by keeping close to the index, returns should be in line with the market, but the higher beta small caps offer the chance of outperformance.

FLEXIBILITY

While fund managers have been using this method for years, intermediaries across Europe have in the main stuck with the well-known balanced mandate approach, in which their clients' portfolios contain a mix of high and low beta holdings. Although both strategies have their advantages, one of the main differences between the two is the added flexibility, and potentially lower cost, that core/satellite offers.

The change initiated in the French pension system may have created interest in this area again, but really it has been the wide adaptation of exchange traded funds (ETFs) across Europe that has boosted the recent popularity of the strategy.

ETFs are a low-cost form of tracking fund that are easily

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traded, making asset allocation switches cheap and quick to make. A few years ago only the main equity indices were available, but today there is a wide range on offer and even a gold ETF that was launched early in 2005. Core/satellite is becoming increasingly prevalent. For large institutional investors this is quite new, as they have always leaned towards the balanced mandate approach. We believe that the market’s understanding of running cheap cores has mostly increased because of ETFs, while increased availability always unleashes pent-up demand for new products.

LOW EXPENSE

ETFs have some of the lowest expense ratios among registered investment products, with the annual expenses deducted from dividend payments and most typically paid out on a quarterly, bi-annual or annual basis. As ETFs settle just like any other shares on the exchange they appear more transparent than some trackers and, depending on the fund management group offering them, have varying degrees of tracking error and associated costs.

According to data included in Morgan Stanley’s global ETF summary (January 2005 edition), comparing the average annual charges, the highest charges on actively managed equity funds are found in Ireland, Italy, Luxembourg and Spain while funds domiciled in Belgium, Germany and Sweden have the lowest. The total expense ratios of these mainstream actively managed funds range across Europe from a mean average of 2.15 per cent in Luxembourg to 1.21 per cent for funds in Sweden, according to the report. Mainstream portfolios are defined as those investing in a domestic market, Europe, global, US or Japan equities.

On the same basis, according to the report, retail shares of index tracking portfolios domiciled in Dublin and Luxembourg have a straight mean average of 1.16 per cent, while ETFs come in at less than half that cost with an average annual charge of 0.51 per cent.

Bruce Lavine, head of iShares Europe, Barclays Global Investors

Risk Warning:
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Established over 30 years ago, Barclays Global Investors (BGI) is today one of the world's largest fund managers. BGI, a subsidiary of Barclays PLC, has a significant international presence, with 10 offices worldwide and a 2,000 strong workforce. We currently manage over £712.6 billion (€1,054 billion as at 30.04.2005) in assets for over 2600 clients around the world.

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