VALUE INVESTING AND RISK MANAGEMENT

WHY EFFICIENT MARKET THEORY IS ONLY FIT FOR LOSERS

Investment managers commonly identify and discuss risk in terms of the deviation from a given index. But there is a different reality for clients who are actually putting their savings into investment products

By considering risk in terms of deviation from a given index, it implies that the only risk an investor can take is to do something different from the index. However, this does not question whether investing in the market is an attractive option or whether purchasing a particular stock poses an investment risk for an investor.

The way that risk is talked about and acted on in the world of investments in general is fundamentally flawed. In my previous career, I acted as a sort of free-wheeling economist who would be brought in to talk to private banking clients.

At one such meeting in 1994, I recall that my company at the time had some investment funds that had performed well relative to their benchmark. However, the benchmark had not performed well.

The investment funds had outperformed 2 per cent in a falling market, which was definitely good. We would happily tell our private banking clients 'Yes, the market fell 10 per cent but you lost only 8 per cent'. The client would then say: 'What kind of idiots are you. Why did you invest if he could see the market was falling?'

Now imagine a different meeting between a fund manager and a pension fund representative for a group of people who are perfectly aware of what alpha, beta, gamma and so on mean in financial terms. These two guys would look at exactly the same situation and agree that the fund manager did a brilliant job. They would have a good lunch, paid for by the pension savers and they would agree that everything is good.

TWO SIDES

We have two completely different ways of looking at the market. The private investor was allowed to haul the fund manager up on his actions but the smaller investor still has to live with the economic reality of what happened. Many members of the investment community sing the same song – and it is one that I have grown increasingly critical of.

Everyone in the investment community is taught that the hero of all things risk-related is Markowitz and his efficient market theory. But I believe that this way of thinking is only fit for losers. It is an outlook that is irrelevant to the people putting money into our investment products.

Using the by now traditional approach, we arrive at

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a situation where risk is defined as deviation from expected market return, so to do a classic 'cover-my-back' manoeuvre, you must do what everyone else is doing. The investment community is effectively encouraged to invest in index stocks – to do anything else is regarded as 'risky'.

If you take a good look at it, this strategy makes no sense. The question 'Should you be investing at all?' is not being asked. It is my strong conviction that this is the central question for most investors, particularly for the end-users. The risk approach as currently applied by the investment industry tends to place less emphasis on this important question.

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RISK AVERSE

If risk is something that you get as soon as you diverge from the market, what do you do if you are risk averse? You do the same thing that everybody else does.

Transparently that is not helpful in many markets, including the current one, as it fails to ask the question: Is it wise to invest in any particular market in the first place?

How has this attitude pushed fund management development recently? In 2000, there were three broad types of funds: a small number of cheap index trackers, a scattering of high-cost specialist, high alpha managers, and then the rest – a large number of managers who more or less tracked the market for a middling fee.

The trend in recent years has been for most fund managers to either reduce their risk by attaching themselves more closely to their benchmarks or to remain occupying the specialist high alpha niche, although generally with slightly lower charges than before. The former have become index-plus managers, and they make up the vast majority of the market.

MANAGING RISK

The risk management role has slipped away from asset managers and moved to institutional asset allocators choosing investment teams, but the end products offered to investors has not markedly changed.

Another strong trend has been the rise of exhange traded funds (ETFs) from investors who suspect that fund managers cannot add value anyway, so they might as well go for a low-cost option; and structured products, on the back of demand from battered investors.

Ironically, ETFs are very popular among structured product creators, who use them to create products with very opaque pricing structures, something that is highly appealing to investment managers who can thereby invisibly ramp up their charges.

TRANSPARENCY

The industry is notoriously uneasy about transparent price structures and investors tend not to be as ignorant as we believe them to be. In fact, they are constantly on our tails trying to find out what it is they are paying for. All of this has led to traditional fund management losing prestige in the market.

At Nordea, the Value Management Team's primary notion of risk is based on the simple observation that cash is the risk-free investment. Any other investment is inherently risky and should only be made if there is an attractive balance between the risk of losing money and the potential of a positive return. Portfolio risk is accordingly controlled, as a secondary element, through diversification.

Kim Asger Olsen, managing director, head of investments, Nordea Investment Funds

Nordea

Contacts:

- Kim Asger Olsen, managing director, head of investments, Nordea Investment Funds S.A., Tel: +352 43 88 73 36 Fax +352 43 93 51, Email: kim.olsen@nordea.lu