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INVESTMENT STYLES

WHEN PRAGMATISM GOES AGAINST COMMON VIEWS

Active, passive, or enhanced indexing? Each investor has his own preference, but a pragmatic analysis leads to conclusions that sometimes go against the consensus

According to a relatively common theory, the choice between active and passive management is simple. In a reasonably efficient market, where news is circulated quickly and widely, stock prices closely reflect all the information available at any given time and active management cannot add value. On the contrary, in an inefficient environment there will be many opportunities for a good manager to identify inadequately priced securities and take advantage of such situations before they have disappeared.

This looks sensible at first glance, although it has a lot of negative implications about the logic and the professionalism of investors and fund managers: why do so many investors in US equities continue to use an active approach if it so obvious that it will underperform ? Why do so few emerging market fund managers outperform indices over the long term if they are working in such an easy environment (see table 1 overleaf)?

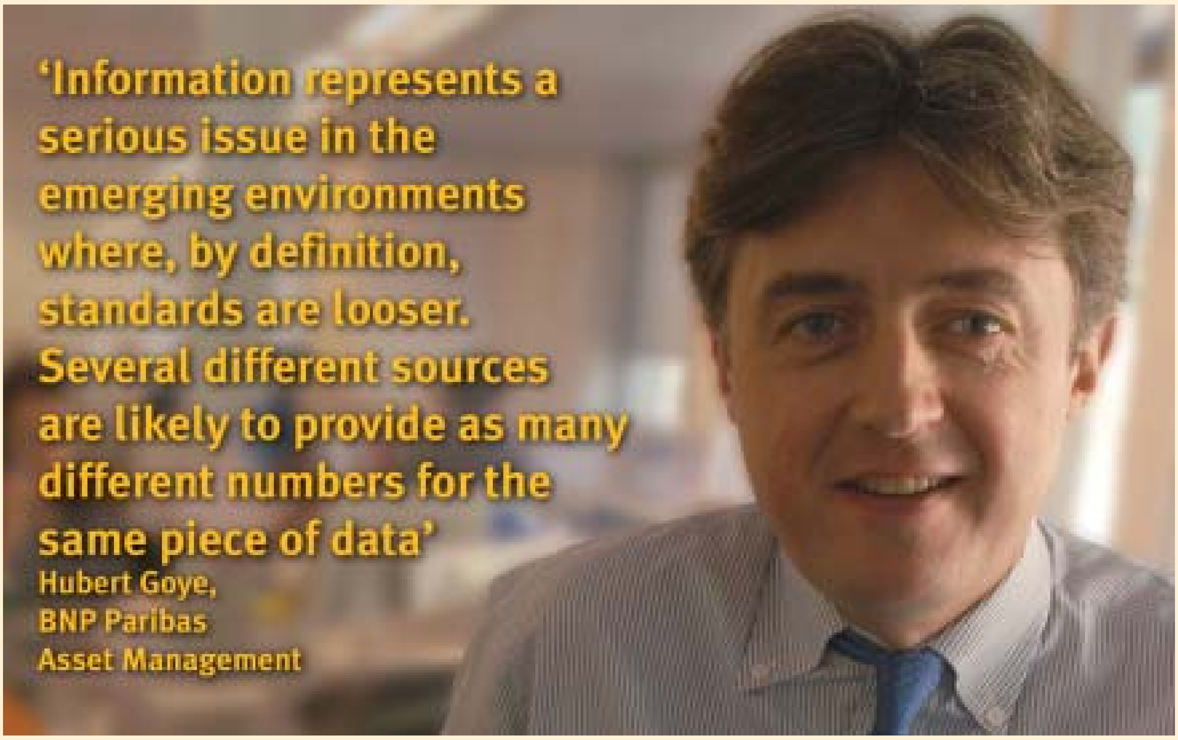
This article discusses a number of principles which, as obvious as they may look at first glance, can be of great help at the time of selecting an investment style.

The first principle is that active management requires investment professionals to be able to make the right decision at the right moment. Key in this respect will be the quality of information, as well as the ability of the fund manager to access it. This is usually not an impediment in most developed markets. Databases and newswires remain subject to a number of inaccuracies (BNP PAM's work on databases even suggests that, in some cases, information technology has helped erroneous data spread throughout the different sources), but they are plentiful and generally reliable.

On the contrary, information represents a serious issue in

INFORMATION

the emerging environments where, by definition, standards are looser. Several different sources are likely to provide as many different numbers for the same piece of data. Regulations and accounting standards are not necessarily enforced, information can be manipulated, and respecting shareholders is far from being a priority for all company managers. For example, just a few years ago, shareholders in a Mexican company were virtually forced to lose their voting rights, on grounds that "it was irrelevant whether or not minority shareholders had voting rights".



1 COMPARED PERFORMANCE OF EMERGING MARKETS FUNDS AND MSCI EM INDEX

Year	MSCI EM Index	Funds' average return	Number of funds beating the index
1990	-13.8%	-11.8%	3/5
1991	56.0%	26.1%	2/13
1992	9.1%	2.0%	4/16
1993	71.3%	68.5%	12/28
1994	-8.7%	-8.3%	21/47
1995	-6.9%	-7.6%	36/78
1996	3.9%	11.4%	72/90
1997	-13.4%	-0.5%	83/101
1998	-27.5%	-28.2%	49/121
1999	63.7%	59.7%	38/113
2000	-31.8%	-29.9%	72/117
2001	-4.9%	-5.2%	64/128
2002	-6.0%	-4.44%	67/128
2003	56.3%	54.5%	39/120

Source: S&P (Luxembourg and Offshore funds)

Only a deeply rooted local presence (in each of the 20-30 emerging countries!) could have a chance to allow a deep enough detection of such specific situations. However, the cost involved remains out of proportion with the size of the assets potentially managed by most investment managers in the emerging markets.

The second principle is that active management will work only if the market reacts logically to news and events. Even if detected properly, market inefficiencies will be a source of value added only if they eventually get corrected.

The challenge in the most efficient exchanges is mainly about accessing information quickly enough, or even anticipating it through leading signs, to be able to take action before the rest of market participants follow the same path and cause a price adjustment. This is why the most successful active managers have extensive on-site research teams, or use quantitative models to crunch massive databases, shorten the time to decision and let human judgment focus on aspects where its flexibility cannot be matched by the computer.

INEFFICIENCIES

The situation is different in the emerging markets, because there is no guarantee that inefficiencies will be corrected. Even assuming that a fund manager would be able to find something that was missed by several million investors, this would not necessarily make his clients rich. The most common reason for this is it may take a lot of time for information to be circulated widely enough for the inefficiency to be corrected in the market (a necessary condition for the investment to prove profitable). Information may also be circulated unfairly, in a way that favors insiders, so that honest market players are likely to arrive too late.

The third principle is that what investors get from a strategy is its return after all costs. In this respect, the first concern is trading costs. While these are in the range of a few basis points in the most mature markets, they may easily exceed a hundred basis points in certain emerging countries.

Brokerage fees are only the visible part of the problem. In most cases, taxes will apply, and the custodian will also take a handling charge. In the least liquid markets, the impact of an order on stock prices (or the need to slow the execution to avoid such impact) can also cause prices to significantly deviate from those prevailing at the time of decision. In the emerging markets, given the poor liquidity conditions, transaction costs remain a structural problem and a significant point against active managers.

Not only these have to include a remuneration for research in the brokerage fees they pay, but beating the index in an unpredictable environment sometimes requires sharp portfolio adjustments and tends to generate a higher turnover than passive strategies.

The second aspect is the level of management fees, which will logically be higher for a research intensive active strategy, specially in the least covered markets.

The fourth principle is that risk aversion should depend on the investment horizon.

It is generally accepted that riskier strategies are more

suitable for investors with a long-term investment horizon, and there is no sign that this principle should be revisited. Their higher risk will hopefully be rewarded through a higher return, while any temporary weakness in performance will not be a major problem since the investor is flexible and can afford waiting for a better timing to get his money back.

RISK AVERSION

However, the core/satellite approach, which has gained traction over the last few decades, is often interpreted in the opposite way. Many investors actually take passive or low risk routes to invest the core of their portfolio, and reserve riskier products for more marginal investments they select to boost their performance. This sounds a questionable strategy in many cases. First of all, the expected excess return of the strategy remains a weighted average of the excess returns of its various components. The benefits of the small investment in the active strategy will therefore be diluted, and almost invisible, in comparison to the much bigger amounts of the core portfolio performing in line with the index. In addition, using a higher-risk strategy to take an opportunistic bet on a temporary market theme involves the possibility that the benefits of an allocation to that theme will be missed, if the active risk taken by the manager happens to play adversely at that specific time.

Pragmatism, which has shaped the BNP PAM equity product line, clearly challenges some of the commonly accepted views about investment styles.

- With sufficient resources allocated to quantitative or judgmental research, it remains possible for active management to achieve its outperformance objective even in the most efficient markets.
- By contrast, active management looks unlikely to add value in the emerging markets, because too many factors (ranging from the lack of information to transaction costs) impede the decision-making process or its implementation in this very specific environment.
- Enhanced indexing, which first requires an alpha generation process and therefore will be suitable only where active management also works well, should be reserved for the markets where a favorable risk /return mix is obtained from active strategies. Otherwise, costs (which remain essentially stable even when the risk is reduced) should be expected to become excessively high in relation to the expected excess return.
- The best performing strategies, whichever they are in each market environment, should be those used for the core of the portfolio, because this is where they will have the best opportunity to prove fruitful despite their sometimes higher risk.

Hubert Goyé, head of international equity investments, BNP Paribas Asset Management

CORPORATE STATEMENT

BNP Paribas Asset Management has €195.6bn of assets under management and is one of the leading players in European fund management. The asset management business employs more than 1300 staff in 20 countries. Its fund management teams are active in all of the world's major financial markets, including Paris, London, New York, Philadelphia and Tokyo and Hong Kong. They are specialised by asset class, investment style and geographical area.

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