Set That Manager Free!

Understanding and Modeling Managers through a 'Degree of Investment Freedom' Framework

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Summary: The potential implications of expanding manager freedom are considerable. We believe that the "Degree of Investment Freedom" framework is essential for understanding the dynamic evolution of the global investment management industry. At its core, DIF is an innovative approach to evaluating and positioning investment products consistent with investor demands to evaluate and set expectations for managers on a broader basis than the legacy approaches available.

Active investment managers have the opportunity to manage money more freely today than anytime in the last twenty-five years. Considering the proclamations of death and disaster for active management at the hands of the 'passive' interlopers, this statement may sound misguided if not an outright misstatement of fact. But examine the rise to prominence of two important product trends following the 2008-2009 industry unsettling: the re-figuring of hedge fund strategies in the form of 'liquid' alternative funds and the resurgence of 'balanced' as multi-asset funds. In terms of new search activity and flows, these two product segments are the hotspots.

Unlike narrower 'specialized' product areas focused on a single market/segment of the capital structure, Liquid Alts and Multi-Asset categories are catchalls - incorporating an increasingly heterogeneous collection of investment strategies. The funds within these categories have the potential to be widely dissimilar in investment technique, exposures and/or process.

Common amongst many newly invigorated and recently launched investment products in these two categories is a high "Degree of Investment Freedom". That is, the managers of these strategies have low levels of investor or self-defined constraints and high levels of flexibility of the fund's management.

'Investment Freedom' is a conceptual framework and tool for understanding, measuring and comparing a broad array of investment funds in common terms. It is, in part, an attempt to address the contemporary environment for product development and assessment in which investment managers are increasingly broadening the tools and techniques used to produce desired outcomes.

Degree of Investment Freedom Map
(Equity Framework)

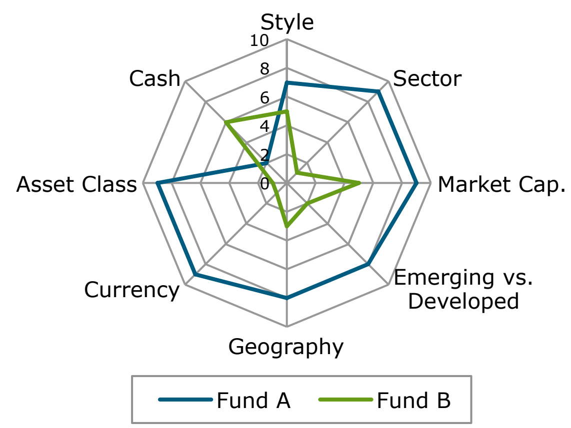

Figure 1.
Source: Propinquity. Note: an illustration, not intended to be all-inclusive

Beyond Active Share

Active share is rapidly emerging as a dominant data point in both manager assessment and product positioning exercises. The growing popularity and strong adoption rate of active share is a clear indication of investors' interest in higher levels of manager activity. It is helping to succinctly distinguish truly active managers from passive. At the same time, its use is enabling a reduction of prescribed constraints. The demand for high active share is a clear indication of investors' desire for a broadening of investment freedoms to drive performance results.

In their 2009 paper, "How Active is Your Fund Manager? A New Measure that Predicts Performance", authors Cremers and Petajisto state: "[A]n active equity fund manager can attempt to outperform the fund's benchmark only by taking positions that are different from the benchmark."[1] It often takes an academic paper to awaken the industry to the obvious. Nonetheless, theirs is a timely presented insight that has opened the link between theory and practice in a remarkable way.

In the future, active share will prove to be an important step in paving the path for furthering of current trends towards the re-emergence of expanding investment freedom for active managers. Considering the direction of the industry today and the rate of changes taking place, that future is arriving more quickly than many would have guessed.

The active/passive debate is once again in full force. The hunt for closet indexers has been reinvigorated. Plenty of investment managers have acted duplicitously; squeaking by, just 'managing to the benchmark.' At the same time, it is important to recognize that the incremental edging towards the near emulation of indices over the last twenty-five years was the result of an investor-driven tightening of constraints. Benchmark hugging by managers has been a response to the demands of investors. The results of which perhaps are best regarded as a function of the law of unintended consequences.

Over this period, the purification of the investment process was driven by asset allocation models delivered to end-clients according to increasingly rigid style, geographical and market capitalization criteria. In many venues, active managers had been rewarded for 'sticking to their knitting' and not veering from their style boxes as prescribed by intermediaries. Being 'too' active was akin to a delicate tightrope walk – a fall marked by underperformance on one side (a result of not enough active share) and style drift (too much active share) on the other.

Intermediaries, from retail advisors to institutional consultants, have long acted as the owners of the end-client relationship and the ardent keepers of the asset allocation process. Empowered by Modern Portfolio Theory, Mean Variance Optimization and ancillary tools, they have been responsible for hiring and firing managers. As such, they have determined just how much investment freedom is given a manager. Until recently, that level of freedom had been, on the whole, low and declining relative to a market index. Alternative investments, specifically hedge funds, had been the traditional vehicle for the manifestation of investment freedom.

Long-only, relative return managers (that is, all managers that were not expressly hedge funds) had been expected to perform two tasks simultaneously - provide both market exposure (beta) and outperformance (alpha). With the ubiquity of market access products (e.g. ETFs) and the ongoing separation of alpha and beta delivery, the focus for active managers must be toward alpha - without exception. Making up for the difference of fees with outperformance is no longer a viable proposition. Where and how manager's produce that alpha is the current subject of inquiry.

It's Asset Allocation, Stupid.

As the product landscape evolves, many broad investment decisions that had been determined and/or tightly controlled at the asset allocation level by intermediaries (e.g. breadth of style, market cap, geographical exposure, etc.) are increasingly being outsourced to external managers. For instance, instead of confining a manager's universe of investable securities to large capitalization stocks only, intermediaries are increasingly inclined to allow managers to invest in stock ideas throughout the range of market capitalizations. This is an expansion of a manager's potential to isolate best ideas and a clear driver of higher active share potential. Bit by bit, the asset allocation decisions that had once wholly been the responsibility of intermediaries are increasingly being shared with managers. This responsibility, along with the popularization of alternative and multi-asset strategies, is crossing from intra asset class to inter asset class decision making.

With greater investment freedom in place, a challenge arises for investors. The less constrained a manager is, the more difficult it is for investors to know precisely how that manager might be positioned. Category buckets (such as 'Multi-Alternative' or 'Aggressive Allocation') are proving less useful in containing and accurately depicting these funds. As more of these funds are incorporated into portfolios, there is a greater level of complexity and challenge for investors.

Investors will need to understand not only the current positioning of such funds but, more crucially, what the composition may entail at any given point in the future. Further, when multiple strategies with high levels of flexibility are combined in a single portfolio, total exposures to various risk premiums, economic/market factors and asset classes are potentially amplified.

Unlike many of the tightly defined index-dependent categories, multi-asset and alternatives are generally not 'allocatable' – they do not have the standardized proxy MPT statistics necessary to project and model performance, risk and correlations. Intermediaries and investors in these products will struggle to utilize them within the traditional frameworks of asset allocation confidently.

How Much Freedom?

Investment managers and their strategies can be understood in terms of the freedoms they may employ to reach their stated investment goals. Plotted in the simplified illustration below (Figure 2) are several sample investment strategies positioned relative to one another. On the lower left are highly restricted strategies. Progressing toward the upper right hand corner, the listed strategies increase in strength of investment freedom.

One can readily consider any investment product – from passive index tracker to a fully unconstrained global 'go anywhere' strategy - within a single framework in the terms of the strength of its Degrees of Investment Freedom value (DIF value).

When understood in the context of investment freedom, the universe of investment managers is

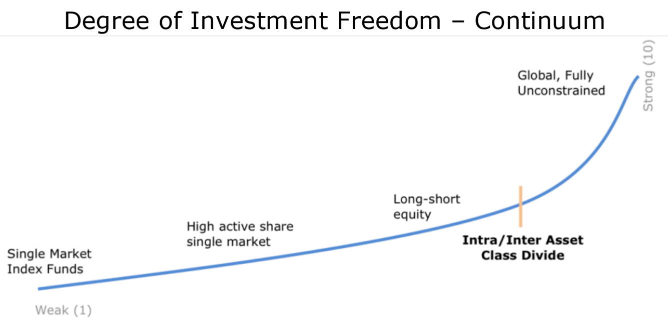

Figure 2.
Source: Propinquity. Notes: an illustration. Not intended to be all-inclusive

broad. On one hand, some managers have tight restrictions and low levels of investment discretion (those toward the left-hand side of the chart). These managers are expected to generate index-relative returns while adhering to rules that define tight alignment to a prescribed index. Their positioning, at any given point in time, can be known with a high level of confidence. On the other hand, other managers have strong DIF values. These managers are able to employ an exceptional range to achieve their investment goals.

In general terms, a manager who is able to go long and short has a stronger DIF value than a manager who can only invest long. Likewise, a manager able to invest globally has a higher DIF than a manager confined to a single geographic market. A manager able to invest across and throughout the capital structure has a stronger degree of investment freedom than a manager only investing in equities or fixed income. Further, within those 'criteria' (e.g. long/short, narrow/broad geography, etc.) there are a range of potential flexibilities. For example, even with a broad range of opportunities to invest in stocks across the world, a manager may still have some limitations on exposures to emerging markets.

There is a broad range of criteria upon which to judge just how free a manager is. Further, based on each of these criteria, it is possible to quantify and therefore rank a fund accordingly relative to other funds. The following illustrates a sample of those criteria.

Criteria	Description/How Determined?
Style	Shift style biases?
Sector	Variety of concentration?
Market Cap.	How wide is the band?
Emerging vs. Developed	Ability to use emerging markets?
Geography	How broad geographically?
Currency	Hedged or currency bet?
Asset Class	Make decisions across asset classes?
Cash	Use cash tactically/strategically?

Figure 3.
Source: Propinquity. Note: an illustration, not intended to be all-inclusive.

The measure of DIF values takes into account the breadth of instruments and techniques that a portfolio manager has at his or her discretion and the manager's flexibility to use them. It may be thought of as a measurement of a managers decision-making and implementation bandwidth. The less constraints, either relative to a market index or in absolute terms, the stronger the DIF of the manager. The criteria outlined in Figure 3 influence the position of a fund on the continuum identified in Figure 2.

Investors expect something in return for allotting an increased degree of freedom. Dolling out more decisions and increased discretion to managers is both an investment and operational risk that must be monitored and potentially mitigated. Investors want to be rewarded for these risks. The stronger the DIF value, the higher the expectations on the part of investors. Further, the more freedom a manager has to manage risks and implement their investment ideas, the fewer acceptable excuses there will be when such goals are not met.

Stronger DIF values also represent a higher level of 'trust' on the part of investors. The more wiling an investor is to turn over asset allocation decision making, the less control they have over the investment manager. Further, in using funds with strong DIF values, intermediaries become more dependent on the manager in determining the end-investors' overall investment 'experience.' This is a central hesitation of intermediaries in thinking about allocating to highly flexible strategies.

Mapping DIF Values

While multiple funds may have strong DIF values, the 'shape' of that freedom may differ significantly. Some fund managers may be able to invest long and short, others may be able to invest in a geographical broad manner, still others may have the ability to invest across the capital structure.

Figure 1 compares the freedom footprints or 'maps' of two illustrative funds. It shows the degree of investment freedom that a manager has in implementing each of the noted criteria. One might consider these criteria as being the 'tools' available to a manager to generate the desired outcome. Each criterion (based on illustration 2 above) is ranked on a scale of 1-10. A score of '1' indicates 'not applicable' while '10' indicates that a criterion potentially could be utilized extensively. In this example, two factors (style and market cap) are equity specific, and two other factors (duration and credit) are pertinent to fixed income. The remaining factors are neutral or potentially applicable to both.

How do these Funds Line Up?

Fund A is a global unconstrained, all-asset portfolio. Without a comparable index, its benchmark is Cash plus 7%. This fund has a strong DIF value (both relative to Fund B and on an absolute basis). Fund A ranks very high (above 7) on several factors. As the fund has a cash plus benchmark, it is expected to produce positive returns in all market environments using a full array of tools. The manager can buy stocks of all varieties in all geographies; it can purchase fixed income instruments across credit and duration ranges. The manager of this fund can make decisions both 'intra' and 'inter' asset class.

Fund B, on the other hand, is a 'specialist' fund focused on bottom-up fundamental selection of US small cap value stocks. It is benchmarked to the Russell 2000 index. While bounded tightly within most criteria, the manager has modest degree of freedom related to decisions about the market cap exposure of the fund and potential to shift along the value-growth spectrum as well as geographical exposures. The DIF values in these areas remain modest. One distinguishing attribute of Fund B is its ability to completely de-risk the portfolio and hold cash.

Fund A has a much stronger factor of freedom than Fund B. In purely mathematical terms, it is three times as free. Nonetheless, the mapping of these two figurative funds' DIF values demonstrate two very distinct footprints.

Conclusion

As the split between active and passive implementation grows, active managers are expected to demonstrate their skills and strength of their investment conviction. Considered in broad terms, the evolving nature of the industry may be considered as a trend from a bounded to an increasingly unbounded environment for managers. More tools and techniques are enabling managers to produce results in a broader range of market scenarios and with specifically defined goals. Investors are giving them the green light. This is all a question of investment freedoms. The Degree of Investment Freedom framework assists in understanding a range of industry trends impacting both product development and management as well as investor behavior.

The potential implications of expanding manager freedom are considerable.

Footnotes:

[1] "How Active is Your Fund Manager? A New Measure that Predicts Performance", 2009. Authors: Cremers, Petajisto. According to the authors, in the early 1990s, the percentage of 'active share' exercised by equity funds fell through the floor. This independently discovered point confirms my own long-standing intuition that 1992 marked the beginning of a long cycle of narrowing investment freedom on the part of managers – a topic I have discussed elsewhere at great length. Propinquity essays since 2009 expound on these topics in great detail.

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