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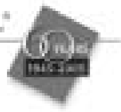
Reflections



The Future of Investment Management

Gary P. Brinson, CFA

Reflection on 35 years in investment management and examination of the present lead to six observations and conjectures about portfolio management.

The reflections and conjectures I am going to share are grounded in my 35 years of experience in the field of investment management. These thoughts cover roughly six—sometimes related, sometimes not—topics. In preparing to launch these observations at the reader, I am mindful of Oscar Wilde's warning: "Experience is the name everyone gives to their mistakes."[1] I will leave it up to you to make your own judgment about whether my "experience" adds any value.

Global Portfolio Construction

The globalization of financial markets, which mirrors the conduct of businesses themselves, will continue to expand in breadth and scope. Constructing portfolios with a home-country bias will become increasingly suboptimal in terms of return and risk.

The process of building global portfolios will change markedly in the future. For example, equity asset allocation driven by country exposure will be replaced by allocation driven by global sectors and industries. Focusing on countries of origin makes no more sense for multinational companies than does emphasizing where in the United States a company is headquartered. More than 70 percent of world equity market capitalization is made up of companies conducting their business on a multinational platform. Does the country in which these multinational companies are headquartered matter? It matters about as much as Microsoft Corporation, for example, being headquartered in the State of Washington. The real issues are where the companies derive their revenues and incur their expenses across the globe and who their competitors are in the global markets. Any thoughtful analyst would be hard-pressed to name an industry in which global competition is absent. Thus, for an investment portfolio, sectors and industries will become the main building blocks of equity exposure.

I do not mean to say that geography is not important to *all* companies. It may be particularly important for some—in small emerging markets, for example. Or if you are invested in a chain of hotdog stands located only in southern California, the geography and climate of southern California matter. For the large multinational companies, however, country is irrelevant.

Currency Exposure vs. Asset Exposure. Unfortunately, the movement to this global portfolio setting has been confused with the notion of currency exposure by some careless researchers. Currency exposure is an important but separate consideration in determining a desired global portfolio array. The attractiveness of an investment asset has nothing to do with its currency, and the attractiveness of a currency has nothing to do with a portfolio's asset holdings.

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An investor can have any currency focus or mix that is deemed optimal, irrespective of the underlying assets in the portfolio. Establishing and managing currency exposure is a straightforward process—no more daunting than the process for determining the asset allocation mix itself. It is a mystery to me why investors continue to confuse their determination of an appropriate asset mix with an appropriate currency mix. People still say, "Oh, well, I'm not going to (or I'm going to) invest in XYZ region or country because I don't like the currency (or I do like the currency)." To the contrary, successful global portfolios will be obtained, managed, and analyzed when asset mix and currency are seen as distinctly separate characteristics.

Return–Risk Relationships of Global Portfolios. An interesting characteristic of portfolios that span the asset allocation array across all of the global markets is that they display a return and risk relationship that dominates any individual asset class. In other words, their Sharpe ratios are decidedly better than anything an investor can achieve by using traditional techniques.

Investors with an appetite for low levels of risk and volatility can best maximize their results by owning a combination of a global portfolio and short-term cash equivalents rather than shifting their investments to asset classes with lower volatility. Similarly, investors with an appetite for high levels of risk can maximize their results by borrowing and leveraging up a global portfolio rather than shifting to asset classes with higher volatility. For example, over extended time periods, a global portfolio levered up to the volatility of equity markets provides returns significantly above the equity returns themselves. So, the notion of an optimal portfolio that is often discussed in the theory of finance does, in fact, exist in this global form, and leveraging this portfolio either upward or downward to a particular desired risk habitat will produce results clearly superior to traditional approaches for managing risk exposure that tilt portfolios toward higher- or lower-risk asset classes.

The Future: Continuous Markets? A final note on global investing is worth considering. In the future, asset markets will increasingly resemble currency markets, in that they will transact over 24-hour periods without defined opening and closing prices. Portfolio pricing will be set to an agreed Greenwich Mean Time to facilitate uniform reporting for clients, but the markets themselves will become continuous and globally available. Present discussions surrounding the "day of business" for the NYSE are only the beginning of this inevitable development.

Investing vs. Trading

Confusion abounds about the distinction between trading and investing. *Trading* is focused on short-term price changes that occur for any variety of reasons. *Investing* is a process focused on future economic cash flows from business activities that ultimately determine the value of an investment. Both activities merit attention to their respective risk and return characteristics—but with decidedly different time frames.

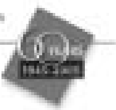
In the future, our profession will best serve all investors if the distinction between these two activities is clearly and forcefully made. The notion of "momentum investing" is an oxymoron. This momentum strategy is more aptly labeled "momentum trading," albeit with a somewhat longer time frame than arbitrage trading.

Bubbles in financial markets have existed for centuries and will not disappear, but perhaps investors' experiences will be less painful when they appreciate the distinction between trading and investing. The landscape is littered with failures from investors losing their way, thinking that their portfolios reflected an investment strategy when, in fact, the portfolios were nothing more than momentum-following trading vehicles.

Fundamental Expectations

In the future, investment analysis will become more rigorously grounded. Decision-making models have evolved nicely during the past 35 years, but unfortunately, inputs to the models have not. Careless assumptions, often not explicitly presented, have led investors to erroneous conclusions from model outputs. This condition is true for the markets in general and for individual companies in particular.

An example of this carelessness is associated with equity valuation models and their growth-rate inputs. Over a vast sweep of history dating from 1947 through 2004, the real (inflation-adjusted) growth trend rate of profits per share for the S&P 500 Index has been 1.8 percent annually. This finding is a simple empirical fact, and it holds equally well for full profit cycles within the 57-year span



regardless of whether profits are defined as operating or reported. The dividend growth rate is somewhat lower, at a 1.2 percent annual real trend rate over the full period, although the rate is closer to the growth path of EPS when adjusted for share repurchases by companies in lieu of dividend payments.

If a typical model input is for a 7 percent nominal growth rate for EPS associated with the S&P 500, in an assumed inflation environment of 2.0–2.5 percent, then the implied real growth rate is in the range of 4.5 percent to 5.0 percent. This rate is far in excess of past experience, yet it reflects a fairly typical set of assumptions from analysts who should know better.

If one wishes to contend that 4.5–5.0 percent real EPS growth will be the obtained trend in the future, then one should be ready with a rigorous argument delineating what variables are changing and why they would cause the historical trend to leap from 1.8 percent to a much higher level. Such rigor is conspicuously absent. People may argue for any future growth rate they desire, but they need to defend their forecast in a rigorous fashion. Demands for this rigor in investment analysis will accelerate in the future as investors seek to explain disappointing results relative to model outputs achieved with careless input assumptions.

A brief comment is warranted here on the distinction between *reported* profits and *operating* profits. While operating profits *may* be appropriate for use with an individual company whose past record is devoid of the special write-offs and allowances depressing reported profits, they are totally inappropriate for a portfolio of companies, such as in the S&P 500. Quarter after quarter, year after year, the companies in this index have economic events that lower reported profits relative to operating profits. Which companies have write-offs changes from period to period, but the events for the index as a whole remain and are remarkable in their persistence. Why, then, would any reasonable analyst suggest using operating profits to guide them in their valuation of the S&P 500? Here we have the case of reported profits being, in fact, true operating profits because the write-offs are persistent and ongoing. If an individual company had persistent adjustments to reported profits, no analyst of any merit would insist on using the so-called operating profits as a guide to measuring the company's record or current valuation. The use of questionable operating profits is yet another example of where some investment professionals seem to have lost their focus in making distinctions important to credible analysis.

In addition, many pension plans and much promotional literature provided to individual investors make unreasonable assumptions about future expected investment returns. Historical returns from markets, unless properly calibrated, are not a sensible guide for setting future expectations. For example, from 1981 through the end of 2004, the annual return from a high-grade bond index was 10.0 percent; yet, not even an elementary student of finance would use that period of substantial declines in interest rates from an exceptionally high starting point as an indicator, given the level of interest rates today, of future returns. Claims made for stock market returns based solely on historical returns are analogous.

Today's investment market fundamentals and financial variables clearly suggest that future real returns from a mixed portfolio of stocks, bonds, and other assets (such as real estate) are unlikely to be greater than 4.5–5.0 percent. With an inflation assumption of 2.5 percent, nominal returns greater than 7.0–7.5 percent for these portfolios are unrealistic. Yet, many retirement plans continue to use much higher expectations for returns.

Fees

Investors will alter their acceptance of fees in the coming years. The future trend in fees, both institutional and retail, will almost certainly be downward. Fees cannot be avoided, but the level of fees associated with a given asset size will be influenced by increasingly aware buyers of investment management services. One need only measure the aggregate fees that are paid by investors as a group with the aggregate value added by their investment managers to see clearly that something is greatly amiss.

When high fees are the topic, the subject of hedge funds naturally comes to mind. Hedge funds are conceptually a great idea because they introduce the notion that active decisions can be made not only on the long side alone. When opportunities present themselves, investors need to consider what they can sell as well as what they can buy. So, the popularity and growth of hedge funds are understandable.

What cannot be explained is why people are willing to pay the considerable fees that hedge funds charge. Perhaps they are paying for historical returns, for hope, or out of desperation.

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For the markets in total, the amount of value added, or alpha, must sum to zero. One person's positive alpha is someone else's negative alpha. Collectively, for the institutional, mutual fund, and private banking arenas, the aggregate alpha return will be zero or negative after transaction costs. Aggregate fees for the active managers should thus be, at most, the fees associated with passive management. Yet, these fees are several times larger than fees that would be associated with passive management. This illogical conundrum will ultimately have to end.

Active fee structures in the future will be bifurcated into one component for passive management and another component for alpha results. Properly structured, this approach will result in aggregate fees paid that are equal to passive management fees. The result will be sharply lower fees for the industry, with the fee savings passed on to investors in the form of higher net returns. A 25–50 bps a year increase in net returns to investors over a long horizon creates a large differential in net terminal wealth. In my mind, this change is not a question of "if" but "when."

Of course, performance-based fees are not a new concept, but the suggestion here is that they will become the norm and probably be applied in a more fitting fashion than we currently experience. Performance fees should be applied in a manner that conforms to the investor's length of time with the manager, not to some arbitrary time segment, such as a calendar year—unless reset or claw-back provisions (provisions for managers to cover past loses before paying themselves) align the investor's total time-period results with the manager's cumulative performance fee. Any fee larger than the agreed-upon passive fee should be either directly tied to value added relative to a specified benchmark or, for absolute-return strategies, applied to only the return in excess of an agreed-upon fixed-rate return that reflects market interest rates.

Lumpiness and Discontinuities

Successful investment management that seeks to provide value above appropriate benchmarks is a lumpy and discontinuous process. Market inefficiencies within any asset class and across all asset classes ebb and flow, and not in a nice smooth and predictable fashion. Managers and their clients need to do a much better job in the future of recognizing this characteristic of markets.

Successfully exploiting opportunities requires variable risk management—that is, varying a portfolio's normal risk appetite to be in alignment with opportunities. At times, perhaps long times, the opportunity set is devoid of value-adding characteristics. At other times, the opportunity set is rich and robust. The barren setting suggests a neutral, passive investment posture with lower risk exposure, whereas the fruitful setting calls for a large appetite for risk relative to the benchmark. My hypothesis, based on some 35 years of investment activity, is that substantial value can be added by active investment strategies but only over long time horizons that allow a manager to capture the relatively infrequent abnormalities when they present themselves.

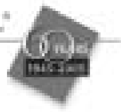
Most investors and their clients avoid this type of adaptive behavior, however, because it appears unstable. The lumpy and discontinuous nature of this management style is uncomfortable for many. (Perhaps this intolerance by clients is one reason the strategy is not more widely embraced and why the reward for the few who follow it is so substantial.) But the markets themselves, with their lumpy and discontinuous opportunities for value-added exploitation, *are* unstable. Insisting on value-added investment results that are inconsistent with the reality of markets only leads to disappointing results.

Random Noise

Investment results are largely random noise. This statement is true even for extended time periods, but it has particular applicability in short-term intervals. By definition, random noise offers no predictive information, which is why past investment performance has no predictive value.

Therefore, the investment management field should ultimately evolve away from using past performance for anything other than its historical accounting value. Organizations that publish evaluations of past performance and imply a valuable predictive insight from such evaluations should be extinct in the not-far-distant future.

Many investors fail to appreciate the nature of random outcomes. For example, if 1,000 people in an auditorium are asked to predict a series of eight consecutive coin flips, two people will call all eight flips correctly and two other people will call all eight flips incorrectly. Neither duo has any particular ability or lack of ability to call coin flips, of



course, nor is there any predictive value from the observed outcome. Both the "winning" pair and the "losing" pair have the same chance of predicting the next coin flip.

This exercise is much like the investment management business: Of the many thousands of managers, the appearance of success for some and failure for others is largely random. Furthermore, predictions of future success or failure based on past results are flawed. I hope that in the future, investors will spend more time and effort on an organization's investment philosophy, process, and people than on past results and, when analyzing past performance data, will apply statistically rigorous performance evaluation.

Coda

This article contains opinions and reflections gathered from my experiences in the investment management profession. Not all of these comments will resonate comfortably with everyone, but I hope some thoughts will inspire and assist the interested investment professional.

Note

1. From *Lady Windermere's Fan* (1892).

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