

Investments Term Paper

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Investment management is the professional management of various securities (shares, bonds etc) assets (e.g. real estate), to meet specified investment goals for the benefit of the investors. Investors may be institutions (insurance companies, pension funds, corporations etc.) or private investors (both directly via investment contracts and more commonly via collective investment schemes e.g. mutual funds) .

The term **asset management** is often used to refer to the investment management of collective investments, whilst the more generic **fund management** may refer to all forms of institutional investment as well as investment management for private investors. Investment managers who specialize in *advisory* or *discretionary* management on behalf of (normally wealthy) private investors may often refer to their services as **wealth management** or **portfolio management** often within the context of so-called "private banking".

The provision of 'investment management services' includes elements of financial analysis, asset selection, stock selection, plan implementation and ongoing monitoring of investments. Investment management is a large and important global industry in its own right responsible for caretaking of trillions of dollars, euro, pounds and yen. Coming under the remit of financial services many of the world's largest companies are at least in part **investment managers** and employ millions of staff and create billions in revenue.

Fund manager (or **investment advisor** in the U.S.) refers to both a firm that provides investment management services and an individual(s) who directs 'fund management' decisions.

Industry scope

The business of investment management has several facets, including the employment of professional fund managers, research (of individual assets and asset classes), dealing, settlement, marketing, internal auditing, and the preparation of reports for clients. The largest financial fund managers are firms that exhibit all the complexity their size demands. Apart from the people who bring in the money (marketers) and the people who direct investment (the fund managers), there are compliance staff (to ensure accord with legislative and regulatory constraints), internal auditors of various kinds (to examine internal systems and controls), financial controllers (to account for the institutions' own money and costs), computer experts, and "back office" employees (to track and record transactions and fund valuations for up to thousands of clients per institution).

Key problems of running such businesses

Key problems include:

- revenue is directly linked to market valuations, so a major fall in asset prices causes a precipitous decline in revenues relative to costs;
- above-average fund performance is difficult to sustain, and clients may not be patient during times of poor performance;
- successful fund managers are expensive and may be headhunted by competitors;
- above-average fund performance appears to be dependent on the unique skills of the fund manager; however, clients are loath to stake their investments on the ability of a few individuals- they would rather see firm-wide success, attributable

to a single philosophy and internal discipline;

- Evidence suggests that size of an investment firm correlates inversely with fund performance, i.e., the smaller the firm the better the chance of good performance.
- Analysts who generate above-average returns often become sufficiently wealthy that they eschew corporate employment in favor of managing their personal portfolios.

The most successful investment firms in the world have probably been those that have been separated physically and psychologically from banks and insurance companies. That is, the best performance and also the most dynamic business strategies (in this field) have generally come from independent investment management firms.

Representing the owners of shares

Institutions often control huge shareholdings. In most cases they are acting as agents (intermediaries between owners of the shares and the companies owned) rather than principals (direct owners). The owners of shares theoretically have great power to alter the companies they own...via the voting rights the shares carry and the consequent ability to pressure managements, and if necessary out-vote them at annual and other meetings.

In practice, the ultimate owners of shares often do not exercise the power they collectively hold (because the owners are many, each with small holdings); financial institutions (as agents) sometimes do. There is a general belief that shareholders - in this case, the institutions acting as agents—could and should exercise more active influence over the companies in which they hold shares (e.g., to hold managers to account, to ensure Boards effective functioning). Such action would add a pressure group to those

(the regulators and the Board) overseeing management.

However there is the problem of how the institution should exercise this power. One way is for the institution to decide, the other is for the institution to poll its beneficiaries. Assuming that the institution polls should it then vote the entire holding as directed by the majority of votes cast, split vote (where this is allowed) according to the proportions of the vote or respect the abstainers and only vote the respondents holding.

The price signals generated by large active managers holding or not holding the stock contribute to management change.

Some institutions have been more vocal and active in pursuing such matters; for instance, some firms believe that there are investment advantages to accumulating substantial minority shareholdings (i.e, 10% or more) and putting pressure on management to implement significant changes in the business. In some cases, institutions with minority holdings work together to force management change. Perhaps more frequent is the sustained pressure that large institutions bring to bear on management teams through persuasive discourse and PR. On the other hand, some of the largest investment managers—such as Barclays Global Investors and Vanguard—advocate simply owning every company, reducing the incentive to influence management teams.

The national context in which shareholder representation considerations are set is variable and important. The USA is a litigious society and shareholders use the law as a lever to pressure management teams. In Japan it is traditional for shareholders to be low in the 'pecking order,' which often allows management and labor to ignore the rights of the ultimate owners. Whereas US firms generally cater to shareholders, Japanese

businesses generally exhibit a *stakeholder* mentality, in which they seek consensus amongst all interested parties (against a background of strong unions and labour legislation).

Size of the global fund management industry

Assets of the global fund management industry increased for the third year running in 2006 to reach a record \$55.0 trillion. This was up 10% on the previous year and 54% on 2002. Growth during the past three years has been due to an increase in capital inflows and strong performance of equity markets.

Pension assets totalled \$20.6 trillion in 2005, with a further \$16.6 trillion invested in insurance funds and \$17.8 trillion in mutual funds. Merrill Lynch also estimates the value of private wealth at \$33.3 trillion of which about a third was incorporated in other forms of conventional investment management.

The US was by far the largest source of funds under management in 2005 with 48% of the world total. It was followed by Japan with 11% and the UK with 7%. The Asia-Pacific region has shown the strongest growth in recent years. Countries such as China and India offer huge potential and many companies are showing an increased focus in this region.

Philosophy, process and people

The 3-P's (Philosophy, Process and People) are often used to describe the reasons why the manager is able to produce above average results.

- Philosophy refers to the over-arching beliefs of the investment organization. For example, does the manager buy growth or value shares (and why), does he believe in market timing (and on what evidence), does he rely on external research or does he employ a team of researchers. It is helpful if any and all of such fundamental beliefs are supported by proof-statements.
- Process refers to the way in which the overall philosophy is implemented. For example, which universe of assets is explored before particular assets are chosen as suitable investments; how does the manager decide what to buy and when; how does the manager decide what to sell and when; who takes the decisions and are they taken by committee; what controls are in place to ensure that a rogue fund (one very different from others and from what is intended) cannot arise;
- People refer to the staff, especially the fund managers. The question is who are they, how are they selected, how old are they, who reports to whom, how deep is the team (and do all the members understand the philosophy and process they are supposed to be using), and most important of all how long has the team been working together. This last question is vital because whatever performance record was presented at the outset of the relationship with the client may or may not relate to (have been produced by) a team that is still in place. If the team has changed greatly (high staff turnover), then arguably the performance record is completely unrelated to the existing team (of fund managers).

Investment managers and portfolio structures

At the heart of the investment management industry are the managers who invest and

divest client investments.

A certified company investment advisor should conduct an assessment of each client's individual needs and risk profile. The advisor then recommends appropriate investments.

Asset allocation

The different asset classes are stocks, bonds, real-estate and commodities. The exercise of allocating funds among these assets (and among individual securities within each asset class) is what investment management firms are paid for. Asset classes exhibit different market dynamics, and different interaction effects; thus, the allocation of monies among asset classes will have a significant effect on the performance of the fund. Some research suggests that allocation among asset classes has more predictive power than the choice of individual holdings in determining portfolio return. Arguably, the skill of a successful investment manager resides in constructing the asset allocation, and separately the individual holdings, so as to outperform certain benchmarks (e.g., the peer group of competing funds, bond and stock indices).

Long-term returns

It is important to look at the evidence on the long-term returns to different assets, and to holding period returns (the returns that accrue on average over different lengths of investment). For example, over very long holding periods (eg. 10+ years) in most countries, equities have generated higher returns than bonds, and bonds have generated higher returns than cash. According to financial theory, this is because equities are riskier (more volatile) than bonds which are, more risky than cash.

Diversification

Against the background of the asset allocation, fund managers consider the degree of diversification that makes sense for a given client (given its risk preferences) and construct a list of planned holdings accordingly. The list will indicate what percentage of the fund should be invested in each particular stock or bond. The theory of portfolio diversification was originated by Markowitz and effective diversification requires management of the correlation between the asset returns and the liability returns, issues internal to the portfolio (individual holdings volatility), and cross-correlations between the returns.

Investment styles

There are a range of different styles of fund management that the institution can implement. For example, growth, value, market neutral, small capitalization, indexed, etc. Each of these approaches has its distinctive features, adherents and, in any particular financial environment, distinctive risk characteristics. For example, there is evidence that growth styles (buying rapidly growing earnings) are especially effective when the companies able to generate such growth are scarce; conversely, when such growth is plentiful, then there is evidence that value styles tend to outperform the indices particularly successfully.

Performance measurement

Fund performance is the acid test of fund management, and in the institutional context accurate measurement is a necessity. For that purpose, institutions measure the

performance of each fund (and usually for internal purposes components of each fund) under their management, and performance is also measured by external firms that specialize in performance measurement. The leading performance measurement firms (e.g. Frank Russell in the USA) compile aggregate industry data e.g showing how funds in general performed against given indices and peer groups over various time periods.

In a typical case (let us say an equity fund), then the calculation would be made (as far as the client is concerned) every quarter and would show a percentage change compared with the prior quarter (e.g. +4.6% total return in US dollars). This figure would be compared with other similar funds managed within the institution (for purposes of monitoring internal controls), with performance data for peer group funds, and with relevant indices (where available) or tailor-made performance benchmarks where appropriate. The specialist performance measurement firms calculate quartile and decile data and close attention would be paid to the (percentile) ranking of any fund.

Generally speaking it is probably appropriate for an investment firm to persuade its clients to assess performance over longer periods (e.g. 3 to 5 years) to smooth out very short term fluctuations in performance and the influence of the business cycle. This can be difficult however and, industrywide, there is a serious pre-occupation with short-term numbers and the effect on the relationship with clients (and resultant business risks for the institutions).

An enduring problem is whether to measure before-tax or after-tax performance. After-tax represents the benefit to the investor, but investors tax positions vary. Before tax measurement can mislead, especially in regimens that tax realised capital gains (and not

unrealised). A successful active manager, measured before tax, can thus produce a miserable after tax result. One possible solution is to report the after-tax position of some standard tax-payer.

Absolute versus relative performance

In the USA and the UK, two of the world's most sophisticated fund management markets, the tradition is for institutions to manage client money relative to benchmarks. For example, an institution believes it has done well if it has generated a return of 5% when the average manager generates a 4% return.

Risk-adjusted performance measurement

Performance measurement should not be reduced to the evaluation of fund returns alone, but must also integrate other fund elements that would be of interest to investors, such as the measure of risk taken. Several other aspects are also part of performance measurement: evaluating if managers have succeeded in reaching their objective, i.e. if their return was sufficiently high to reward the risks taken; how they compare to their peers; and finally whether the portfolio management results were due to luck or the manager's skill. The need to answer all these questions has led to the development of more sophisticated performance measures, many of which originate in modern portfolio theory.

Modern portfolio theory established the quantitative link that exists between portfolio risk and return. The Capital Asset Pricing Model (CAPM) developed by Sharpe (1964) highlighted the notion of rewarding risk and produced the first performance indicators, be they risk-adjusted ratios (Sharpe ratio, information ratio) or differential returns compared

to benchmarks (alphas). The Sharpe ratio is the simplest and best known performance measure. It measures the return of a portfolio in excess of the risk-free rate, compared to the total risk of the portfolio. This measure is said to be absolute, as it does not refer to any benchmark, avoiding drawbacks related to a poor choice of benchmark. Meanwhile, it does not allow the separation of the performance of the market in which the portfolio is invested from that of the manager. The information ratio is a more general form of the Sharpe ratio in which the risk-free asset is replaced by a benchmark portfolio. This measure is relative, as it evaluates portfolio performance in reference to a benchmark, making the result strongly dependent on this benchmark choice.

Portfolio alpha is obtained by measuring the difference between the return of the portfolio and that of a benchmark portfolio. This measure appears to be the only reliable performance measure to evaluate active management. In fact, we have to distinguish between normal returns, provided by the fair reward for portfolio exposure to different risks, and obtained through passive management, from abnormal performance (or outperformance) due to the manager's skill, whether through market timing or stock picking. The first component is related to allocation and style investment choices, which may not be under the sole control of the manager, and depends on the economic context, while the second component is an evaluation of the success of the manager's decisions. Only the latter, measured by alpha, allows the evaluation of the manager's true performance.

Portfolio normal return may be evaluated using factor models. The first model, proposed by Jensen (1968), relies on the CAPM and explains portfolio normal returns with the market index as the only factor. It quickly becomes clear, however, that one factor is not

enough to explain the returns and that other factors have to be considered. Multi-factor models were developed as an alternative to the CAPM, allowing a better description of portfolio risks and an accurate evaluation of managers' performance. For example, Fama and French (1993) have highlighted two important factors that characterise a company's risk in addition to market risk. These factors are the book-to-market ratio and the company's size as measured by its market capitalisation. Fama and French therefore proposed a three-factor model to describe portfolio normal returns. Carhart (1997) proposed to add momentum as a fourth factor to allow the persistence of the returns to be taken into account. Also of interest for performance measurement is Sharpe's (1992) style analysis model, in which factors are style indices. This model allows a custom benchmark for each portfolio to be developed, using the linear combination of style indices that best replicate portfolio style allocation, and leads to an accurate evaluation of portfolio alpha.

Education or Certification

Increasingly, international business schools are incorporating the subject into their course outlines and some have formulated the title of 'Investment Management' conferred as specialist bachelors degrees. (i.e. Cass Business School, London). Due to global cross-recognition agreements with the 2 major accrediting agencies AACSB and ACBSP which accredit over 560 of the best business school programs, the Certification of MFP Master Financial Planner Professional from the American Academy of Financial Management is available to AACSB and ACBSP business school graduates with finance or financial services related concentrations. For people with aspirations to become an investment

manager, further education may be needed beyond a B.S. in business, finance, or economics. A graduate degree or an investment certification such as Chartered Financial Analyst (CFA) or Chartered Alternative Investment Analyst (CAIA) may be required to move up in the ranks of investment management

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