

## THE REAL VALUE OF INVESTMENT SELECTION

The balance between return and risk is often equated with the trade-off between eating and sleeping well. While all investors have an appetite for greater wealth (eating well), they also have a limited tolerance for risk (sleeping well). Unfortunately, risk is a difficult, often abstract, concept for investors—especially when it comes to investment selection. As a result, risk is usually ignored altogether.

**However,** risk is real, whether it is interpreted as the possibility of losing money or the uncertainty associated with achieving a wealth target. One of the most important roles financial professionals play is that of risk manager, working to maximize the probability that the client’s investment strategy will achieve its goal. The goal of risk management is to keep portfolio risk at an appropriate level throughout the investment process, and as important, take risk only where it is more likely to be compensated with return.

This paper explores the value of investment selection by placing it in the context of portfolio risk and return, introducing active risk as the key differentiator between index and active investing, and finally distinguishing between intentional and unintentional sources of risk. Through this lens, investment selection—particularly the choice between index and active investing—becomes a much more important exercise, one that balances performance with portfolio risk.

## PLACING INVESTMENT SELECTION IN CONTEXT

Deciding how to divide wealth among the thousands of possible investment choices is a daunting challenge for even the most experienced investor. And with so much emphasis on investment performance in today’s financial press, investors are apt to focus only on investment selection as the key to a successful strategy. In contrast, the world’s largest investors place tremendous importance on the value of asset allocation, turning to it as their principal tool to fund future needs. For these investors, asset allocation is the primary consideration, and investment selection is a process to implement those decisions. If asset allocation represents a blueprint for diversifying portfolio risk, investment selection represents the bricks and mortar used to execute the design.

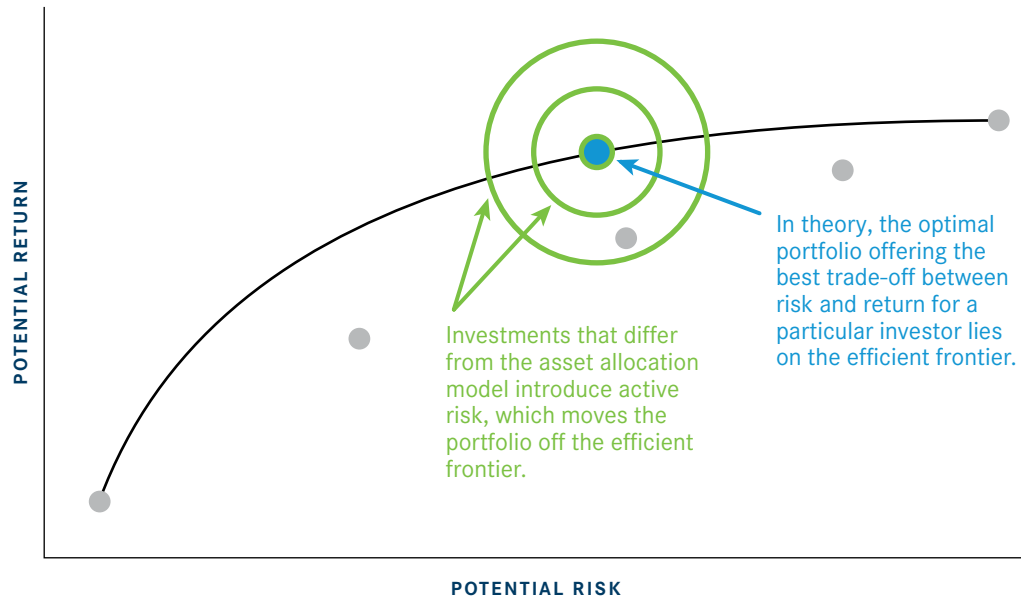
Many investors also tend to evaluate investments in isolation, missing the importance of monitoring the overall portfolio. Again, the world’s largest investors take a different view, treating a portfolio like a sports team, with every player contributing to the success of the overall effort. Each team member has a defined role to play, whether as a first-string punter or a third-string quarterback. While superstars may exist, the success of the team as a whole requires that all players work together toward the same goal. Superstars that “step on the toes” of other players, causing harm to the overall team, are traded for players that understand their role and fit within the entire team.

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In a portfolio, all investments, even top-quartile performers, need to be evaluated for both their individual contributions and the roles that they play in the context of the portfolio. Some investments will function purely as diversifiers, delivering performance that is comparable with the index capturing that market segment. Others may be selected for their extra return potential. These “superstars” should not be evaluated for their return contribution alone, however. The success of the portfolio requires that these investments not only deliver return, but that they also remain true to the role they were drafted to play.

**Figure 1**

Investment Selection Impacts Asset Allocation



## BEHIND THE CURTAIN: ACTIVE RISK

At the heart of investment selection lies active risk, a new idea for nearly all investors. Active risk is important because the investments chosen to fill an asset allocation may fail to deliver on their purpose. Active risk introduces a new uncertainty into the portfolio—the possibility that an investor may not achieve their wealth goals despite a well-laid plan. Figure 1 illustrates how an asset allocation strategy that lies on the efficient frontier may no longer do so once investments have been selected.

Active management offers the opportunity for returns beyond a benchmark. These excess returns are known as active return or alpha. Active managers charge fees for taking bets relative to their asset class benchmark, such as security selection or

sector rotation, that earn active return. Only the very skilled (or very lucky) active managers can be right all of the time, and as a result, there is uncertainty around any active manager's performance. This uncertainty, the volatility of active returns, is active risk (see Appendix 1 for a detailed discussion of active risk and investor appetite for it). Active risk, sometimes known as tracking error, is neither good nor bad. In fact, it is necessary for the pursuit of active return. What matters instead is how active risk is created and managed.

Index investments deliver performance that tracks a market benchmark. They offer targeted exposure to that benchmark index, matching the fundamental characteristics and risks of the index. Because of their objective construction rules and

**Figure 2**

Top Five U.S. Defined Benefit Plans

	% OF ASSET CLASS ALLOCATED TO INDEX INVESTMENTS				
	Total Plan Assets (\$Million)	Total Plan	Domestic Equity	International Equity	Domestic Bond
California Public Employees' Retirement System (CalPERS)	217,648	40%	69%	57%	0%
California State Teachers' Retirement System (CalSTRS)	148,868	40%	75%	39%	0%
New York State Common Retirement Fund	144,289	50%	71%	14%	67%
Florida State Board of Administration	121,871	45%	73%	25%	22%
Teacher Retirement System of Texas	100,717	27%	44%	27%	0%

Source: BGI, *Pensions & Investments*, January 22, 2007.

stable characteristics, indexes are used to develop asset allocation models. To the extent that an index fund tracks the same index used to model the investor's asset allocation (say the S&P 500 Index for large-cap investing, for example), the investor is essentially hitting par—matching the risk and return of the long-term strategic model with their investment selection. Active risk here is close to zero.

## INDEX OR ACTIVE?

The merits of index and active management have been fiercely debated in both academic and popular literature. At the heart of the argument lies the fact that the market represents all participants. In order for someone to outperform the market, someone else needs to underperform it. In addition, for a manager to consistently outperform the market, they need to not only take active risk, but they need to do so skillfully. Active returns generated through luck—instead of investment process—are unlikely to lead to outperformance again in the future. Because consistent active returns require skill to achieve, not all active risk is compensated with active return.

As a result, deciding whether to use active management requires believing two tenets:

- Good, skillful active managers exist who can consistently deliver alpha relative to their appropriate benchmark; and
- The investor or financial professional has skill in identifying the best active managers.

The debate between index and active management is not one centered around whether good active managers exist—they most certainly do. Instead the debate revolves around whether the average investor can identify good active managers in advance. Large institutional investors rely heavily on both index and active investments. As Figure 2 shows, the five largest U.S. defined plans allocate between 27% and 50% of their assets to index investments. In addition, the allocation varies by asset class: domestic equity allocations are 44-75% invested in index investments, while international equity allocations are 14-57% invested in index investments, for example.

While institutional investors continue to make extensive use of active investments, they also place great emphasis on taking active risk only when they are likely to be consistently compensated for bearing that risk. The downside of missing their funding goals is too great to take unwarranted, uncompensated, and unintentional risk.

Until recently, active strategies represented the primary avenue for average investors to build globally diverse portfolios that mimicked those of institutional investors. Today's investment universe is exploding with index products designed to deliver access in nearly all the same categories. As a result, investors not comfortable with taking on active risk can create purely indexed portfolios that have the greatest likelihood of matching their asset allocation and wealth strategies. Or like institutional investors, investors can mix index and active investments that thoughtfully balance risk and return.

### WHEN ALPHA ISN'T WORTH THE PRICE: UNINTENTIONAL RISK

In contrast to institutional investors, the average individual investor uses active strategies as core positions, filling U.S. large-cap or international slices of an asset pie, for example. In this role, active strategies fill a designated asset class, or beta, exposure, with a goal of delivering excess returns relative to that asset class's benchmark.

So what happens if a U.S. large-cap active manager outperforms their benchmark by investing in international securities? On the one hand, the strategy has delivered exceptional performance. On the other hand, the manager has inadvertently jeopardized the investor's wealth strategy—the investor has now taken on a different risk profile (with a greater exposure to international investments) than they intended. While the strategy may pay off in the short-term, there is no guarantee that the manager's insights will continue to deliver in the long-term. In addition, if the international market experiences a downturn, the investor will clearly suffer losses from their international investments; but they will also have the unpleasant surprise of losing more money than expected from their U.S. investments (unless the active manager has perfect foresight!).

This example highlights the importance of managing and minimizing unintentional sources of risk—a central consideration in investment selection. Unintentional risk arises when the risks sought by the investor differ from the sources of risk actually delivered by the investment. Style drift is one of the most common sources of unintentional risk, but others might include simply not having enough transparency in a strategy to evaluate its risk. Active risk may be the avenue to active return, but it is only worth taking if it is intentional, managed, and likely to be compensated.

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### THE ROLE OF THE RISK MANAGER

Given investors' limited appetite for risk, financial professionals can further differentiate their services by offering thoughtful investment planning—including investment selection—with risk management as a key cornerstone of that process. In fact, many financial professionals have turned to conversations about the importance of risk management to highlight their expertise and the value of their advice.

Understanding and managing active risk is a central component of that advice. Through thoughtful investment selection, financial professionals strive to improve the probability that an investor will achieve wealth goals laid out in the investment strategy. Ultimately, the goal of risk managers is to ensure that all risk is intentionally taken. And strategies that manage risk at all stages of the investment process ensure that no amount of a client's risk budget is misspent.