The Economist Alpha betting

*The industry is splitting in two—and investors are gambling on the expensive bit*

Sep 14th 2006|

IT HAS never been easier to pay less to invest. No fewer than 136 exchange-traded funds (ETFs) were launched in the first half of 2006, more than in the whole of 2005. For those who believe in efficient markets, this represents a triumph. ETFs are quoted securities that track a particular index, for a fee that is normally just a fraction of a percentage point. They enable investors to assemble a low-cost portfolio covering a wide range of assets from international equities, through government and corporate bonds, to commodities. Morgan Stanley estimates that ETFs control some $487 billion of assets, up 16.7% from a year ago. It predicts they will have $2 trillion of assets by 2011. No longer must investors be at the mercy of error-prone and expensive fund managers.

But as fast as the assets of ETFs and index-tracking mutual funds are growing, another section of the industry seems to be flourishing even faster. Watson Wyatt, a firm of actuaries, estimates that “alternative asset investment” (ranging from hedge funds through private equity to property) grew by around 20% in 2005, to $1.26 trillion. Investors who take this route pay much higher fees in the hope of better performance. One of the fastest-growing assets, funds of hedge funds, charge some of the highest fees of all.

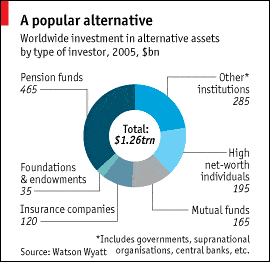
At first sight, this might seem like a typical market, with low-cost commodity producers at one end and high-charging specialists at the other. Buy a Rolls-Royce rather than a Trabant and you can expect a higher standard of luxury and engineering in return for the much greater price. But fund management is not like any other industry; paying more does not necessarily get you a better service.

An index represents the average performance of all investors, before costs are deducted. If the fee paid to the fund manager increases, the return achieved by the average investor must decline. After fees, hedge-fund returns this year have been feeble. From January 1st through to August 31st, the average hedge fund returned just 4.2%, according to Merrill Lynch, less than the S&P 500 index's 5.8% total return.

So why are people paying up? In part, because investors have learned to distinguish between the market return, dubbed beta, and managers' outperformance, known as alpha. “Why wouldn't you buy beta and alpha separately?” asks Arno Kitts of Henderson Global Investors, a fund-management firm. “Beta is a commodity and alpha is about skill.” The fund-management splits began with the decline of balanced managers, which took complete charge of an investor's portfolio, running everything from American equities through Japanese bonds to property. Clients became convinced that no one firm could produce good performance in every asset class, nor could they master the art of timing the switch from one asset to another.

**Core and Satellite**

That led to the “core and satellite” model, in which part of the portfolio was invested in index trackers with the rest in the hands of specialists. But this created its own problems. Relations with a single balanced manager are simple. It is much harder to research and monitor the performance of specialists. That encouraged the middlemen—managers of managers (in the traditional institutional business) and funds-of-funds (in the hedge-fund world).



They are usually even more expensive. Managers of managers, such as Patrick Disney of SEI (Europe), say they can use their buying power to keep fees down to the level charged by individual specialist managers. But even that tends to be higher than the charges of a traditional balanced manager, let alone an ETF.

That such fees endure might suggest investors can identify outperforming fund managers in advance. However, studies suggest this is extremely hard (hence the rubric routinely attached to British financial products, “Past performance is no guarantee of future returns”). Nigel Williams of Barclays Global Investors, a big index tracker, says that consistently outperforming the market is hugely difficult. And even where you can spot talent, much of the extra performance may be siphoned off into higher fees. “A disproportionate amount of the benefits of alpha go to the manager, not the client,” says Alan Brown at Schroders, an asset manager. And yet investors may be willing to gamble, despite the higher fees, because they desperately need high returns. The bear market between 2000 and 2002 brought a sober reassessment of the future returns likely from equities and bonds. With bonds yielding 4-5% and equities returning perhaps 3% on top, composite future returns of 6% or so looked inadequate. Peter Harrison, chief executive of MPC, a fund manager, says that American pension funds have analysed their liabilities. “They need more than 6% to make up the shortfalls in their funds. Whether they earn alpha or not, they have to roll the dice and try to get it.”

The same rationale led to the enthusiasm for other forms of alternative assets, such as property and commodities. These appeared to offer a different source of returns that was not closely correlated to shares or bonds. The problem is that, as more money has piled in, the character of such assets have changed (see [article](https://www.economist.com/finance-and-economics/2006/09/14/the-slippery-slope)). Prices have risen (reducing prospective returns) and exotic assets are more correlated with run-of-the-mill ones. Diversification is supposed to be the one “free lunch” in the financial markets. However, these new market niches may be too small to absorb the amount of capital investors would like to place in them. Furthermore, top-performing managers, especially in hedge funds, may well close their doors to new investors to prevent returns being diluted. Even when you can identify the most skilful manager, it may be impossible to invest with him.

Nevertheless investors will probably keep pursuing alpha, even though the cheaper alternatives of ETFs and tracker funds are available. Craig Baker of Watson Wyatt, says that, although above-market returns may not be available to all, clients who can identify them have a “first mover” advantage. As long as that belief exists, managers can charge high fees.