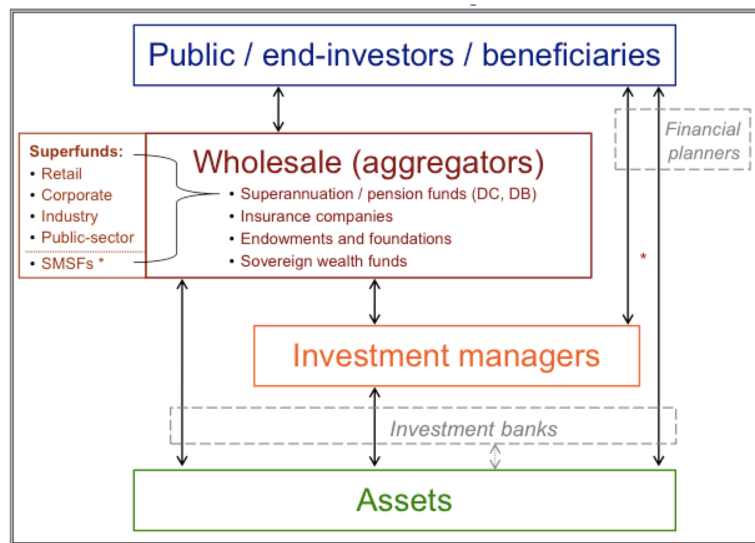
FINM3008 Notes

Portfolio Management

- Managing invested funds towards objectives
    - What objectives? e.g. return, risk, liquidity, steady income stream, dividend vs capital gains, tax minimization
    - Identify key objectives for the portfolio
- Portfolio managers (PMs) – delegated the authority, responsibility and accountability for investment performance

Structure of the Industry



Players

- Overall plan
    - board of trustees (fiduciary duty)
    - investment management staff (day-to-day running of fund)
    - asset consultants (advice)
    - implemented consulting (advice + implementation)
    - sponsoring entity (unique to superannuation funds)
        - More important in DB as they bare the risk
- Investment managers
    - traditional, hedge funds, partnerships, LLCs, fund-of-funds, ETFs
    - pooled funds versus separately managed accounts
        - Separately managed accounts are only worthwhile for fund mangers if the individual has large amounts of capital – Asking for a unique portfolio
        - Fund managers follow investment mandate/goal for pooled funds
    - roles: CEO, CIO, PMs, analysts, client relationship managers (sales), risk officers, performance measurement, back-office

- Distribution
    - wholesale versus retail
        - Retail – mum & dad investors
    - Direct (to end investor), via financial planners, brokers, platforms: e.g. Macquarie Wrap or BT Wrap

AGENCY ISSUES

- Delegated management => agency problems
    - The principal (end-investor) delegates management of their portfolio to an agent (manager)
    - Portfolio manager is managing other people's money, rather than their own
        - Decision on who's best interests to act on – Own or client
- What investors want versus what managers want – conflicts of interest
    - Everyone wants greater return, but can everyone get what they want?
    - E.g. optimal size of funds/assets under management (AUM)?
        - Fund management company vs end investor: ↑ AUM will ↑ profit for company, but too much AUM can erode excess return for end investor
            - Large funds can't gain as large profits as small funds due to price impact – Eg. arbitrage opportunity would be corrected by fund's investment
        - fund manager vs end investor: want to ↑ profit for employer BUT
        - fund management company versus fund manager: manager salary, reputation can be tied into their ability to generate excess return
- Asset 'buckets' and benchmarks
- Most caused by lack of alignment between incentives/objectives (rather than informational asymmetry)

Examples

- Fund management companies and fund managers have incentive to increase fees and FUM (profits and bonus motives), while investors want to maximise portfolio return
    - Managers want to keep fees as high as possible, but this directly reduces investor returns
    - If FUM increase beyond reasonable capacity for strategy, return are eroded
    - Result is that much of the value-add from investment skill may be secured by manager themselves, rather than accruing to investors
- Managing benchmarks
    - Benchmark need not align with investor objectives
    - Managers may game benchmark by either seeking risk premiums or off-benchmark exposures
    - Varying risk to mange relative performance

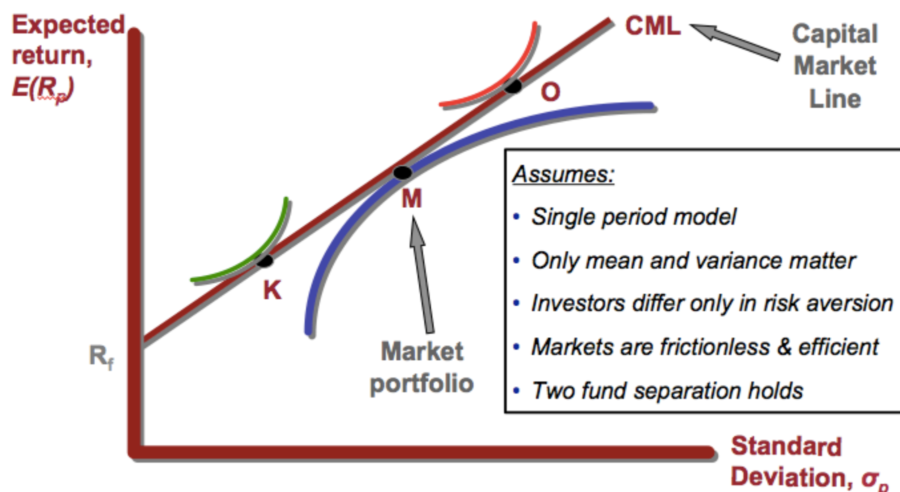
        - Eg. Hug benchmark is ahead, go for broke if behind
        - Investor get not enough risk, or too much
- Peer ranking considerations
    - Reluctance to try something new, even if in investor's best interest, as raises risk of underperforming peers
    - Manager 'career risk' (being worst performer and losing job) leads to benchmark hugging and other forms of herding
- Ongoing evaluation of manager performance
    - Can lead to short-sightedness
    - Managers trying to maximize short-term returns, rather than long-term performance
- Incentives to increase risk when 'optionality' exists for manager (eg. bonus paid on yearly returns, performance fees, or high leverage)
    - Options are more valuable under high volatility -> Incentive to take risk
    - Investor subjected to more risk than appreciated
    - More of an issue in hedge funds, private equity, etc.
- Brokerage and other costs paid by investor, but controlled by manager
    - Open for abuse by manager – Brokers can offer benefits to manager (eg. entertainment) to get them to trade
    - Example: 'Soft dollar' transactions – Involve brokers paying for certain services in return for a promise to pay brokerage
- Commissions on product sales
    - Investor directed towards mangers paying highest front-end loads and trailers, not necessarily best managers for investor

AN ASSET MANAGEMENT DECISION PROCESS

- **Plan**
    - Governance *(week 12)*
    - Objectives & constraints *(week 2)*
    - Asset allocation *(weeks 3-5)*
- **Implement**
    - Asset class strategy & portfolio structure *(weeks 6-10)*
    - Manager or asset selection *(weeks 11-12)*
    - Execution *(weeks 11-12)*
- **Review**
    - Performance measurement & evaluation *(week 12)*
    - Monitor & adjust *(week 12)*

RECENT INDUSTRY TRENDS

- High growth rates (faster than GDP)
- Growth segments:
    - Alternative assets: Private equity and hedge funds, commodities, and infrastructure
    - ETFs
    - SWFs (Sovereign Wealth Funds) – Particularly emerging markets
    - Private wealth management



- Two fund separation – All investors only invest in two portfolios: R_f or M
  - All different combinations of the two

Theoretical Issues with Traditional MPT

1. Investment horizon in undefined
   - Yet it matters, especially if returns are not iid
   - Depends how long your losses/gains can accumulate or how long to recover
2. Single period model
   - Real world is multi-period, with changing investment opportunities
3. Assumes risk aversion is the only difference that matters
   - Other investor differences matter, eg. objectives, liabilities, investment horizon, opportunities, costs, taxes
     - Eg. some assets are only available to sophisticated investors, not everyone can borrow at the same rate
   - Separation' -> investors hold combination of M and Rf -> Unlikely in practice as different portfolios may be optimal
4. Portfolio optimization across all available assets
   - Not necessarily feasible
     - Curse of dimensionality – Very difficult to model due to data available

Enduring Messages from MPT

1. Diversify
2. Correlation matters
3. Risk should be defined in a portfolio context

How Portfolios are Built in Practice

- Influence of industry 'norms' (traditionally equity-dominated portfolios)
- Legacy portfolio as starting point, with marginal changes
- Tiered approach to portfolio construction (division into buckets: portfolio => asset classes => asset managers => assets)
- Widespread pursuit of active returns ('alpha')