
Multi-Asset Investing in Asia Pacific: A Practitioner's Framework

Pranay Gupta, CFA
Director, Curriculum Projects
CFA Institute
Hong Kong

To provide investors with what they truly want—absolute return—the investment industry needs to change its structure. Critical to this change will be a focus on asset allocation as opposed to security selection. Definitions of risk premiums and active strategies should be revised, and greater emphasis should be put on managing allocations to risk exposures.

Suppose we could eliminate the current structure of the investment industry, wipe the slate clean, and build the industry from the bottom up. One way to start the rebuilding process is to ask, “What is the basic objective of this industry?” From individual investors to endowments to sovereign wealth funds—all have one basic objective: to have sufficient assets at all future times to fund their expected liabilities. An endowment needs to fund university expenses. A pension plan needs to fund retirees. A sovereign wealth fund needs to fund a development plan. Individuals need to fund their children’s college education or their own retirement. All asset owners have an objective of absolute return. Thus, the ultimate objective of the investment business is to create asset values that allow clients to remain in surplus above their expected liabilities. We need to generate absolute return.

The problem is that the investment industry is not structured to achieve its basic objective. What is needed is a structure, especially for the way portfolios are organized and managed, that will allow the industry to do what its clients actually expect.

What Asset Owners Want

Asset owners have three concepts in mind when they seek out the assistance of investment professionals:

1. Absolute return
2. Risk constraint
3. Periodic review of investment results, which is much shorter than the long term

Editor's note: Mr. Gupta is now head of multi-asset strategies at Fullerton Fund Management, Singapore.

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Absolute Return. When individuals ask investment professionals to manage their money, they do not arrive talking about diversification in a 60/40 market portfolio. They may have a general understanding of such terms, but what they want is an actual return based on their calculations of how much money they need to fund specific liabilities, such as retirement or a college education. Institutional investors may be more sophisticated in their understanding of investment concepts, but they also want an actual number, such as a 7% return.

Risk Constraint. Something else investors consider is a risk constraint. Risk is an amorphous concept that investors and investment managers understand and articulate in different ways. In the industry, we talk in terms of volatility or tracking error, and we try to assure investors that we will never allow their portfolios to reach their specific risk threshold. For investors, risk is about loss. Whether the loss is permanent or transient does not matter. All investors have a firm idea of the maximum loss that they are prepared to accept, even when they are perfectly certain that their investments are absolutely right.

If I am a perfect stock valuation expert, I may know that 10 years from now a specific stock will be, without a doubt, the right stock to own. But if during those 10 years I lose half my money in that stock, I may panic and sell. In that case, I will never realize the final expected return. This is a behavioral aspect of investing that we cannot ignore. More than that, it is also a structural, regulatory aspect. In the United Kingdom, for example, when the asset-liability gap for an insurance company reaches a particular threshold, the regulator will prevent the company from issuing new policies. Regulations in the Netherlands force pension funds to de-risk assets when they breach a particular asset-liability gap.

The structure of the investment industry forces a hard stop. It is like a gambler going into a casino with limited funds. The casino knows that in certain games, the probability of winning is in the gambler's favor, but the casino also knows that all gamblers have a specified limit of funds and that once those funds are exhausted, the gambler will reach a hard stop and leave. The hard stop for a casino is much greater than that of its customers, so the casino counts on being able to hang on longer than its customers can, which is why casinos always win. Likewise, investors often fail to realize their target returns because they capitulate and sell when they hit their hard stop.

Long-Term Horizon, Short-Term Measurements.

All investors are told that investing for the long term is one of the keys to success. Pension funds specifically insist that investing for the long run is a skill they exploit. They ignore all the short-term market noise and focus on long-term results—or so they say. But the truth is that investment portfolios are managed by individuals, and each one of those individuals has a boss, and each one of those individuals and bosses, all the way up to the boardroom, is confronted by mark-to-market values of their investments every quarter. If the portfolio or a strategy underperforms for one, two, or five quarters, the boss will be knocking on the door. So, the talk and even the intention may be all about the long-term horizon, but evaluations and decisions are done on a much shorter term.

Even the smartest pension plan managers and asset owners have been confronted by this dichotomy between intentions and reality. I began wondering about this dichotomy between the needs of investors and the inefficiencies of the investment industry about five years ago when I was asked by an Asian sovereign wealth fund, "What would you do if you were given \$100 billion, with the mandate to create a new pension plan from a clean sheet of paper? Would you arrive at the same investment and organizational structure for the fund as is prevalent in most pension funds today?"

To begin formulating an answer to this question, I had to evaluate the investment process as it now exists.

Traditional Investment Process

The majority of people in our business are agents rather principals, including the employees of the largest asset owners in the world. They do not own the money, so they do not experience the intensity of loss when loss occurs.

In the traditional process, investors determine the target annual return they require to fund their

liabilities. Depending on the level of sophistication of the investor, this target can be determined by estimation or an actual asset–liability study. Investment advisers then determine an appropriate asset allocation plan, which is dominated by equity investments, fixed income, and alternatives. After that, investment managers are chosen for each of the asset classes.

According to basic financial concepts, about 80% of the risk and return in such a portfolio comes from the initial asset allocation decision. Stock selection contributes the remaining 20%. Yet 80% of investment professionals in our industry are stock selectors, not asset allocation specialists. In investment banks, 80% of the investment staff members are stock or bond analysts; in asset management organizations, 80% of the products are stock or bond selection products; and even in asset owner organizations, 80% of the staff is engaged in hiring and firing relative-return managers. The resource allocation that exists across the industry is misaligned with the actual sources of risk and reward. The industry is focusing on the wrong problem. Manager selection and stock selection are of limited use if the bulk of your risk and return come from elsewhere.

Assumptions of the Traditional Process.

Traditional asset allocation is based on the following fundamental assumptions:

1. Investment in multiple asset classes provides diversification.
2. Equity investment provides a long-term risk premium.
3. Asset class silos provide clear separation of skill.
4. Alpha and beta separation is necessary.
5. Active management adds alpha.
6. Alpha is diversified by using multiple active managers.
7. Asset management organizations are structured correctly.

Flaws in Traditional Assumptions. In the Asia-Pacific region, asset allocation in liquid assets is generally done using eight asset classes—four equity regions (the United States, Europe, Japan, and Asia), three fixed-income categories (sovereigns, credits, and high yield), and commodities. **Table 1** shows these eight asset classes, with gold standing in for commodities. For each asset class, I present (among other things) the annual mean return and the maximum drawdown (max DD). Note that all four equity classes have experienced a maximum drawdown of 50% or more, which means that although equities might offer a return of about 3% above cash, they also present the risk of losing half of their value midway on the journey toward the investor's long-term horizon.

Table 1. Descriptive Statistics for Various Asset Class Market Benchmarks (2000–2014)

Short Name	Description	Annual Mean Return	Annual Volatility	Sharpe Ratio	Max DD	ER/Max DD
EQ US	MSCI USA	3.2%	16.1%	0.05	51%	0.02
EQ EU	MSCI Europe	2.1	16.7	-0.02	50	-0.01
EQ JP	MSCI Japan	-2.6	18.2	-0.27	57	-0.09
EQ APEX	MSCI All Country Asia Pacific ex Japan	12.6	22.6	0.45	62	0.17
FI GOV	Barclays Global Aggregate Government (H)	5.7	3.4	1.01	4	0.83
FI CORP	BofA ML Global Broad Corporate (H)	6.2	4.3	0.87	11	0.34
FI HY	BofA ML Global High Yield (H)	8.5	11.0	0.55	33	0.18
GOLD	Gold spot price	17.2	17.5	0.84	26	0.58

Notes: Base currency is in US dollars. (H) indicates foreign exchange (FX) hedged; equity indexes are all FX unhedged. FI CORP is selected from Bank of America Merrill Lynch (BofA ML) rather than from Barclays because of its longer history. Correlation over the intersecting period is 99.5%. The mean return is calculated as an arithmetic mean. The Sharpe ratio is calculated using the one-year US Treasury yield. ER/Max DD is excess return (over risk free) divided by maximum drawdown.

Similar issues arise with traditional diversification assumptions. Many managers argue for diversification among all of the eight asset classes. But the correlation between the four equity asset classes and high yield is 80%–90%. So, although there is some diversification among US, European, Japanese, and Asian equities, what matters is the amount of equity generally in a portfolio.

Just as equity has an equity beta, fixed income has a credit beta. If we extract the credit beta from investment grade and then run a correlation with global sovereigns, the correlation is about 90%. As with equities, therefore, the diversification that is supposed to accrue from having several different fixed-income classes is a myth, which leaves the investor with only two decisions: how much equity to hold in the portfolio and how much credit.

Although alternative asset classes are supposed to offer a beta of zero, the correlations between liquid hedge fund categories are also quite high.

Now consider the risk premium provided by equity. If an investor were to hold an equity on a static basis for 50–60 years, a risk premium would accrue. The average excess return above cash for such a period is indeed about 3%. But the actual realized return in an asset owner's portfolio is a function of when the equity exposure was created. Because asset owners generally create a strategic allocation in a policy portfolio for three years and rebalance their allocations, the realized return can be plus or minus 10%. Furthermore, if a plan has a 60/40 portfolio and also does dynamic allocation, its impact is limited to about 5% of the equity exposure.

Similarly, investments in emerging markets have an even higher risk premium and higher growth. The average risk premium is indeed 7%–8% over the long term, but the higher volatility in emerging markets means that actual returns can be plus or minus 50%,

depending on the timing of investments. So, the risk premium is available, but investors cannot be certain they will get it, which is a significant shortcoming in the traditional allocation process—neither diversification nor the risk premium is as readily available as expected.

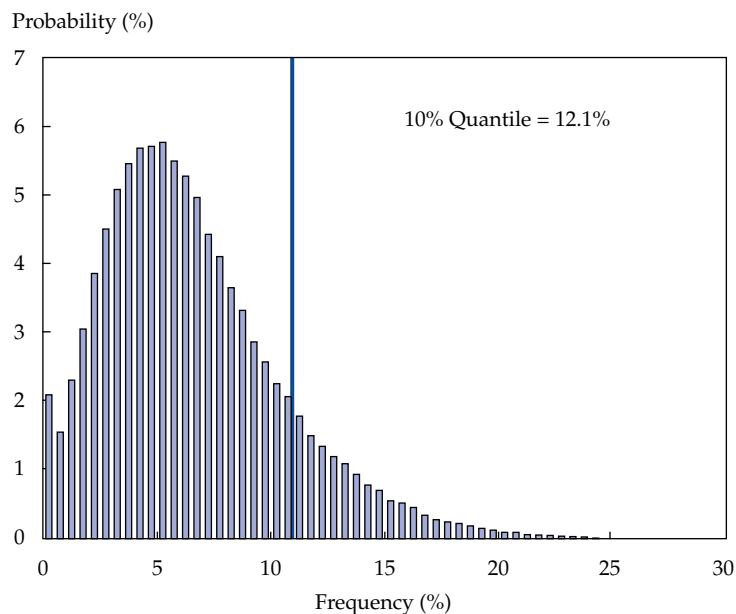
Fundamental Flaw of Traditional Process.

Suppose I have a time machine, and on 1 September 2016, I can go forward one year to 1 September 2017 and observe the performance of the eight asset classes. When I return to 1 September 2016, I decide to buy the two asset classes that I know will perform best for the next year. Every year after that, I travel forward in my time machine, return with perfect foresight of the coming year, and buy the best two asset classes. Consequently, I have the perfect look-ahead portfolio because I have perfect skill in making my asset allocation.

Of course, in reality, I do not own a time machine, and I have allocation skills lower than perfect, so I cannot always buy the top two performing asset classes. I may end up buying the second- and third-best performers or the third- and fourth-best performers. But if we examine the drawdown characteristics of the perfect foresight portfolio, we can conclude that even if I have perfect skill and know exactly what the future holds, my portfolio still has a 90% chance of losing 12%, as shown in **Figure 1**.

The lesson is that the allocation of assets is far more difficult than stock selection is, which may be a reason why the investment industry does not focus on it. Sponsors implement a long-term policy portfolio and neatly translate the investment problem to a relative-return framework. Most multi-asset funds in the industry today have a benchmark made as a composite of traditional market asset benchmarks, and they again focus on a relative-return game. Delivering absolute return is a difficult task, but absolute return is exactly what the client wants.

Figure 1. Top Two Performers: Frequency Diagram for the 12-Month Maximum Drawdown



Note: Based on 10,000 simulations of 12 monthly returns with annual volatility and mean for first- and second-best performers.

Limitations of Current Allocation Framework. Three limitations define the current allocation framework and make the investment process far less effective than it should be.

First, although asset allocation can be done in many different ways, every asset owner and manager in the investment industry follows a single allocation strategy for the entire investment process. The allocation decision is, therefore, not diversified. The industry takes great pains to advise clients to diversify their relative-return manager risk by employing multiple managers, but for the part of the investment process that affects 90% of risk–return, we do not create any diversification at all. Everyone follows a single process.

Second, because there is only one allocation strategy, there is only a single time horizon. The manager space encompasses high-frequency managers, mid-term managers, long-term managers, and various active managers, but asset allocation in every investment firm is done with a single time-horizon forecast. There is no time diversification.

Third, we know that if an asset suffers a drawdown during the investment period, this intra-horizon risk is a real risk for investors. Even if investors find the perfect investment, they must be able to stomach the intra-horizon losses while they hold that asset. Otherwise, they will sell the asset if the drawdown breaches their tolerance threshold of maximum loss and fail to realize the asset's

benefits. Even if individuals or institutions are willing to absorb the intra-horizon loss, the regulatory and governance framework in the industry prevents them from retaining high-drawdown assets. The definition of risk in modern portfolio theory, despite the use of asymmetric risk measures, is based on end-of-horizon risk. We do not measure, let alone manage, intra-horizon risk in line with the risk aversion of the asset owner.

New Framework Based on Absolute Return

Evidence indicates that the investment industry needs a new framework built around absolute return. Several developments need to occur before such a framework can become the norm in the industry.

Seven Actions toward Achieving Absolute Return. Seven actions are required to manage money in the interest of getting an absolute return.

1. Mitigate the dependence of portfolios on a single parameter, such as the target weight of equities in the portfolio.
2. Stop relying on skill in timing equity markets. History shows that market timing cannot be done successfully.
3. Redefine risk to include intra-horizon draw-down risk.

4. Establish a mechanism to restrain drawdown to within a specified threshold.
5. Position hybrid asset products and alternatives within the same silos, not as a separate asset class. Traditional asset classes no longer fit into neat categories. They exist today as a spectrum of different instruments across the capital structure.
6. Structure alpha–beta analysis for fee calibration, not for portfolio structure. No one disputes that skill in producing alpha should be rewarded nor that managers should know which part of their return comes from alpha and which from beta and pay appropriately. But the alpha–beta divide should not dictate how organizations and products are structured.
7. Know the risk in a portfolio in any dimension at any time.

Three Steps to a New Framework. To implement these seven actions, the industry must first take three simple steps.

1. Incorporate multiple allocation processes with different investment horizons.
2. Design and implement a true risk measure.
3. Transition to an exposure-based framework.

■ *Multiple processes and multiple time horizons.* We know that having multiple strategies makes sense because multiple strategies increase diversification. But with a single allocation strategy, investment firms are tied to a single efficient frontier, so whenever a client has a higher return requirement, investment managers must move along that frontier and increase return by increasing the risk. Aside from leverage, that is the only option available. But as soon as investment managers increase the number of allocation strategies in a portfolio, the frontier moves up because when allocation strategies are diversified, managers can keep the same risk level and still get a higher return. And if return requirements remain unchanged, diversified allocation strategies can decrease portfolio risk.

Experts sometimes debate the differing advantages of risk allocation, factor allocation, and traditional asset allocation. But the fact remains that no process works at all points in time. Every process has a performance cycle. Therefore, any investment firm choosing a single allocation method will eventually pass through a cycle of underperformance. Some allocation processes will work at certain times; others will work at other times. But nothing prevents a manager from using an array of allocation methods.

Multiple allocation strategies provide diversification where it is needed. Methods that are higher frequency need to be invested in derivatives, rather than in active strategies. Other methods will allow investors to hold the same assets for a long time, so they may be able to take advantage of active

management if they believe that alpha is available. Derivatives for countries, sectors, or style will be used. The active–passive decision at the security selection level will, therefore, become obsolete.

■ *Creating a true risk measure.* Conventional methodologies for estimating risk are really estimating the probability of having a drawdown at the end of a holding period. But such estimates are contingent on the manager and client retaining the asset until the end of the holding period and ignoring the existence of intra-horizon risk aversion.

Consider a security with a 5% expected appreciation during a two-year planned holding period. During the investment horizon, as the asset price fluctuates, if the security drops to a level greater than the loss threshold of the investor—say, 20%—the investor will capitulate and sell the asset and never realize the eventual expected return, even if it is a certainty. So, even as we estimate return and end-of-horizon risk, we must also estimate intra-horizon risk, the path that an asset will follow to reach the end of its holding period. Only then can investors really know the risk–reward trade-off for any investment.

We know that every investor and institution has a threshold of maximum loss for any asset investment that acts as a hard stop loss. This threshold is sometimes even determined by the regulator as a governance structure for institutions. This hard stop loss does in fact determine the portfolio’s maximum investment horizon. The longer the expected investment horizon, the higher the probability of intra-horizon loss.

Consider the question, “What is the probability that the market will decline by 20%?” If this question is asked for an extremely short period, then the probability of a 20% decline will be extremely low. But if the question is asked for a long period, such as 10 years, then the probability of a 20% decline will be almost a certainty. As the investment horizon is extended, the probability of an intra-horizon drawdown increases.

A risk parameter that combines both intra-horizon and end-of-horizon risk allows a manager to build a preferred loss threshold into the portfolio.

■ *Exposure-based framework.* Fifty years ago, the active strategy for a US portfolio manager of S&P 500 Index stocks might have been nothing more complicated than to buy low price-to-earnings stocks to outperform the benchmark. Market return was the only factor classified as a beta. Following the work of Fama and French, the book value strategy was institutionalized and became a systematic factor. So, the low price-to-earnings strategy had become a beta, and the manager had to find a new alpha-generating process. Over time, more factors were added, such as size and book value. Such factors started to explain

parts of a portfolio's return. In general, as we shift from a CAPM to an arbitrage-pricing theory-based framework, the return of any asset or strategy can be seen as a function of its different risks. The alpha-beta distinction is, therefore, only a distinction of which risk factors have become commoditized in terms of the availability of an inexpensive liquid instrument and which have not. Value is now a beta. Small cap is also a beta because managers can easily buy the Russell 3000 Index. Such factors are no longer alphas because they have become betas. The alpha manager must keep searching for new ways to generate alpha. The line between alpha and beta keeps moving as the commoditization of exposures keeps happening.

All investment managers who strive to differentiate themselves in terms of strategy or technique are basically picking up a defined set of risk exposures as a focus and packaging them together into a product. All strategies are simply a combination of different risk exposures, some of which we may call alpha and some beta. A passive strategy provides a set of securities that replicates the first beta, which is market risk. A fundamental index strategy provides two betas, such as market beta and value or market beta and dividend. An active strategy can use top down or bottom up, fundamental or quantitative, or other risk exposures. Alternative strategies are the same as active strategies, except that the managers are able to short as opposed to going long only. Every investment strategy is essentially a collection of betas.

Trying to apply an exposure-based framework to run an organization and overcome the traditional structure is difficult. One can hardly change what asset managers do. But organizational leaders can create an exposure-based risk analysis, which means that every portfolio is analyzed according to the exposures it provides without worrying over what is active and what is passive. Once the risk exposures are clearly identified, a fund can then decide which exposures to allocate to and which skills to buy.

What is the impact of establishing an exposure-based framework? First, portfolio return is explained by a series of risk factors that the portfolio takes exposure to and achieves return. Second, every characteristic of an investment is acknowledged as both a risk factor and a return generator. Third, the list of risk factors can include anything, even

subjective risk factors, such as management changes, restructuring, and market shares. Fourth, portfolio exposure to a risk factor and risk factor premium are acknowledged as time varying.

Furthermore, the definition of active and passive changes completely. In reality, there is no passive strategy because the client benchmark is cash. Fundamental indexation and portable alpha are also obsolete because they are merely packaging different betas. The definition of equity risk and credit risk changes. If we use academic definitions, equity risk and credit risk overlap with each other, which is sub-optimal for allocation purposes.

Even more fundamentally, the compensation of portfolio managers and the structure of organizations have to change. Greater resources and skills need to be deployed for allocation, where they can have the greatest impact, and the management of portfolio risk has to improve. As investors explore smart beta and other new products, the resources and the skill base will shift from selecting stocks toward allocation.

Conclusion

The following points are essential to understanding the real needs of our profession and our clients.

1. Allocation is the real active management problem, not security selection.
2. A multi-strategy approach to allocation is required, instead of security selection.
3. Incorporation of intra-horizon risk in the investment decision is paramount.
4. There is nothing similar to a passive strategy. All investment strategies are active decisions with respect to a client's benchmark.
5. An exposure-based framework is critical for analyzing the risks inherent in any investment strategy.
6. If we are to deliver what asset owners really require—absolute return—the structure of the investment industry has to change dramatically to favor more resources for the allocation investment decision.

Question and Answer Session

Pranay Gupta, CFA

Question: How does your definition of multi-asset differ from the traditional concept of a 60/40 portfolio?

Gupta: The way I define multi-asset is basically that any portfolio that invests across multiple instruments is effectively a multi-asset problem. The biggest problem for an investor in this context is the allocation problem. A macro hedge fund is an allocation problem. A 60/40 balanced portfolio and a target-date fund are also multi-asset problems. The multi-asset strategy is distinct from the single-asset-class portfolio, where the problem is picking stocks or bonds.

Question: Do managers in Asia-Pacific markets perform differently from managers in developed markets?

Gupta: Among developed market managers, approximately half of the active managers outperform and half underperform. But among Asia-Pacific equity managers, about 75% underperform. Only a quarter outperform. Furthermore, if you look at the performance of Asian managers for three consecutive years, which is the average intended holding period, the 25% of outperformers shrinks to 5%. So, only 5% of active managers actually outperform consistently over a three-year period for Asian equities.

Even worse is how they move from outperformance to underperformance. These managers rarely move from the top quartile to the second quartile. The highest probability is that they move from the top quartile to the bottom quartile, which implies to me that they are still trying to time the market.

There may be an issue in the way portfolios are managed in Asia versus the United States because they have tried to copy the processes used by developed market managers. If you look at the dispersion of securities in the S&P 500, 70%–80% of the dispersion is available for stock selection decisions. Only about 20% comes from allocation. So, a US equity manager focusing on stock selection is appropriate. But in Asia, about 66% of the return dispersion is available for allocation decisions. Only 34% comes from stock selection. But managers from Hong Kong to Singapore will go out of their way to tell you that they go to every single country pounding the pavement, and they pick stocks. Even the good managers say this. So, my explanation of why Asian managers underperform is that they are focusing on the wrong investment decision because they are trying

to exploit only 34% of the dispersion and ignoring the remaining 66%.

Question: Does active management in general have skill, or is it more a matter of luck?

Gupta: That is the wrong question to ask. There will always be good managers and bad managers. One group will never dominate over the other. The more appropriate question is, do you have the skill to pick an outperforming manager?

If you are a treasury assistant in a company, you probably have only the most general understanding of investments and probably do not have the knowledge and skill to pick a skilled manager. In that case, investing passively is the right strategy. But if your organization does have the resources and ability to pick a skilled manager, then you should go active. So, it is a function of what skill you have in picking the right manager rather than asking if active is good or passive is good, because there will always be managers on both sides.

Question: Are the asset class correlations you discussed of similar magnitude when seen in the context of a single market like India?

Gupta: Resident Indians, of course, cannot invest in global asset classes, so the only two asset classes available to them are domestic equities and domestic bonds. Although I have not tested a universe this narrow myself, I believe that the broad concept would still be valid.

Question: What kind of asset classes would you consider for a multi-asset strategy? For example, would art or real estate be an asset class for investment?

Gupta: In my analysis, I have focused only on liquid asset classes, the eight asset classes I described—the four equity regions (the United States, Europe, Japan, and Asia), the three fixed-income categories (sovereigns, credits, and high yield), and commodities. Illiquid assets are difficult to model in this context because the frequency of marked-to-market data is limited.

But it should be possible to model illiquid asset classes using liquid assets as a proxy. For example, private equity has the same exposure as listed equity. It just has an additional risk of being illiquid, which generates a liquidity risk premium. Venture capital is an early stage of equity. And convertible bonds are a hybrid of debt and equity.

In my proposed framework, different instruments are simply a package of risk exposures.

Whether art or wine represents consumption or an investment asset class is debatable. During the bull market in Brazil, people were finding odd lots of Brazilian land and calling that an asset class. Unless a category gives you a regular return, it is probably not an asset class.

Question: Does a multi-asset strategy incorporate rebalancing?

Gupta: Yes. If you are investing in multiple asset classes, you need to rebalance, just as you would in any portfolio. The parameters that determine the rebalancing strategy of a multi-asset portfolio are not that different from those for a single-asset-class portfolio—transaction cost, investment horizon, turnover, and frequency of rebalance.

Question: Does the longer holding of any asset class—for example, land, gold, or cash—represent a risk?

Gupta: The earlier comment about intra-horizon versus end-of-horizon is a mathematical fact for all investments. If you extend your investment horizon, your end-of-horizon risk decreases, but your intra-horizon risk increases. That holds true for any kind of investment.

At first glance, land and property appear to stand apart from this assertion. First, they are not marked to market, so when their value drops by 20%, investors do not experience the loss, and even if they do, they cannot sell immediately anyway. Second, land and property tend to be less volatile than a listed asset class, such as equities. Mathematically, it is absolutely true for any kind of investment that if you lengthen your time horizon, you increase your intra-horizon risk.

Question: Does alpha–beta separation provide any benefits for investors or managers?

Gupta: The benefit of analyzing how much of a portfolio's return comes from beta is that you can calibrate the worth of the return. Beta is cheap, and alpha, in contrast, is expensive because it is scarce and difficult to get. So, you do need to separate the two because you need to know what to pay for, and you should be paying for alpha only. But you do not have to separate your organization into alpha managers and beta managers. All alpha comes packaged with various kinds of beta. You need to identify the exposures you are buying in a product and hence determine what part of the return is coming from real skill.

Question: Is illiquidity risk factored into the alpha–beta model?

Gupta: All of the analysis that we have done is in liquid assets. So, illiquidity from the perspective of illiquid asset classes is not considered. But illiquidity as a risk factor in liquid markets is included. But the concept is the same—if you put your money into an asset that has liquidity risk, such as private equity, you have to know whether you are getting paid for the illiquidity risk you are bearing because of the lockup that you have.

Question: Can you explain how your definition of risk premium differs from the traditional definitions?

Gupta: Conventionally, the definition of the equity risk premium is the long-run return on equities minus the risk-free return, and the definition of the credit risk premium is the credit return minus the risk-free return. Both definitions make perfect sense when considered independently. But in an allocation framework, you need to have buckets that are mutually exclusive. So, equity risk and credit risk cannot overlap.

If, for example, you are getting a 10% return on your equities but your local State Bank of India bank account is also offering a 10% return, why would you stay in equities? The only reason to go into the equity markets is to get a better return than your bank account. Similarly, if you can get 14% on an investment-grade bond, then you should expect an even higher return from equities.

The real return from the equity market, the reason to take that additional risk, is to gain the surplus above 14%. It is not the surplus from the risk-free return. When you create an allocation structure and you look at the premiums that you have in your different asset classes, they have to be laddered. They cannot be overlapping with each other. This makes a lot more sense from an allocation decision perspective.

Question: Would factor-based allocation solve the issue?

Gupta: It can help. The debate about factor allocation is over the assertion that it is a better way of allocating assets than traditional allocation. That may not be correct because managers still have to forecast the factor returns. No evidence yet shows that we can forecast factors better than asset classes or regions.

What factor-based allocation does offer is a different methodology for allocation. So, there will be times in the market when factor allocation is the more stable source of return, and there is no reason to exclude it. But the same holds true for all other methodologies. A manager who combines style allocation, factor allocation, traditional asset allocation, long-term risk premium, and short-term allocation

has a more robust set of tools for allocating among the different asset classes.

Question: Can the use of fundamental indexation improve returns?

Gupta: The concept of fundamental indexation or smart beta simply proposes that there is a more efficient way to get exposure to a market when compared with a market-cap index. That argument is probably correct. But it does not mean that smart beta is a better way to manage money or that you

should charge more for it. If the client benchmark is absolute return, then smart beta is probably no smarter than ordinary beta. Smart beta does not forecast asset prices; it just picks a weighting factor other than market cap.

Nevertheless, smart beta does put two betas instead of one in your portfolio, so if you go passive, smart beta provides a better alternative than pure market cap beta. But you should not be paying active management fees for it.