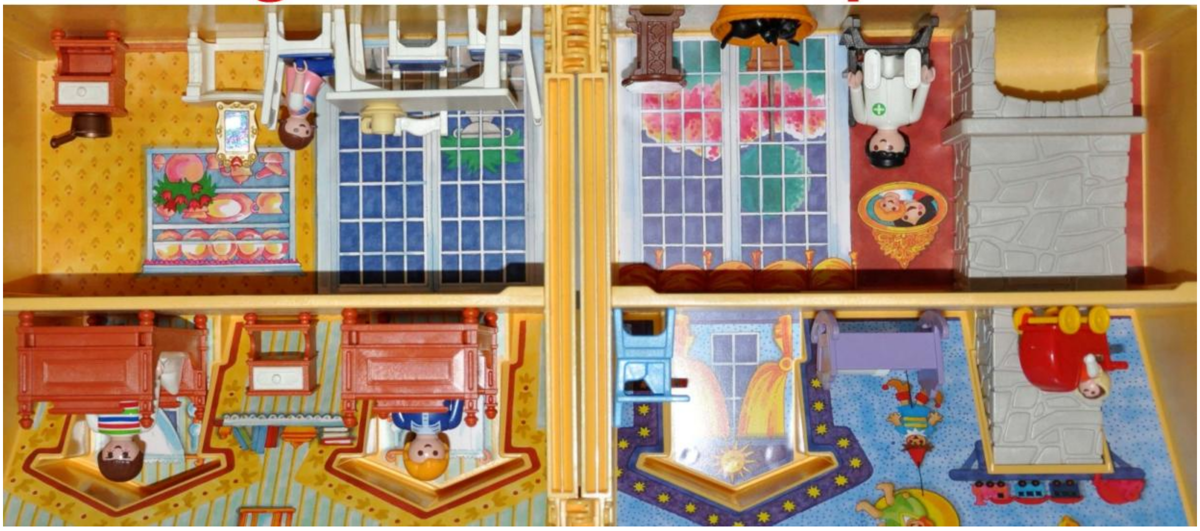
Investing needs to be turned Upside Down



The incumbent structure of investment processes pervasive in our industry is to FIRST perform asset allocation, typically to equities and bonds, and THEN within each asset class bucket either select managers or securities. In a single country framework this is fine, but in a global investment framework, is this actually correct? Maybe it should be turned on its head and done exactly the other way around. Select your allocation to each country first, and then decide equity-bond allocation within each country independently.

Problems with the Current Approach

1. The singular equity-bond allocation concentrates total portfolio risk on this single decision. Subsequent decisions of securities and manager selection do little to mitigate the portfolio drawdown of the asset owner when markets fall.

2. It forces the investor to make a generic decision of positioning within the capital structure (i.e. favor equities or debt) for all countries collectively. This doesn’t make sense. It is obvious that in some countries, one may want to favor debt investments and in other countries equity investments, but the current framework doesn’t allow that.

3. It makes the assessment of total portfolio risk very difficult. While it is relatively straight forward to calculate risk within an equity only portfolio or a within a fixed income only portfolio, calculation of risk in a multi-asset class portfolio is non-trivial. The current structure is able to assess equity risk and fixed income risk, but is extremely poor at assessing and managing overall portfolio risk.

4. Management of FX risk often done well by Fixed Income PMs and done very poorly by Equity PMs in the current structure. So total FX risk is often not managed well.

Turning the Investment Approach Upside Down

So what if we FIRST did country allocation, and THEN decide where to position in the equity-debt capital structure continuum within each country? This has many advantages-

1. The equity bond decision is now taken many times, independently for each country, thereby decreasing risk concentration.

2. It is conceptually easier to decide positioning within the equity-bond continuum for a single country, one at a time. There are no cross-country risk issues, more plausible macro frameworks possible and minimal currency issues.

3. It is much easier to create a multi-asset risk framework for a single country, as there are minimal currency and country risk issues and the issuers are often the same for the different securities. Assessment and management of overall portfolio risk thus improves significantly.

4. FX risk can be managed for the overall portfolio, rather than just for the fixed income portfolio.

This framework has dramatic consequences for our investment industry across market indices, investment products, investment processes and portfolio management. But the key is …its probably a lot better for the asset owner.