
Edhec European Asset Management Practices Survey

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Outline

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- Investment services
- Portfolio management process
- Performance analysis
- Risk management

Objectives of the study

- Assess the degree to which European asset management firms' practices correspond to the most recent research in the asset management field;
- Identify the potential gaps with regard to the strategic and regulatory environments of the respondents;
- Establish a basis for a permanent observatory of asset management companies' practices.

Methodology

Survey on asset management companies' practices

Sample

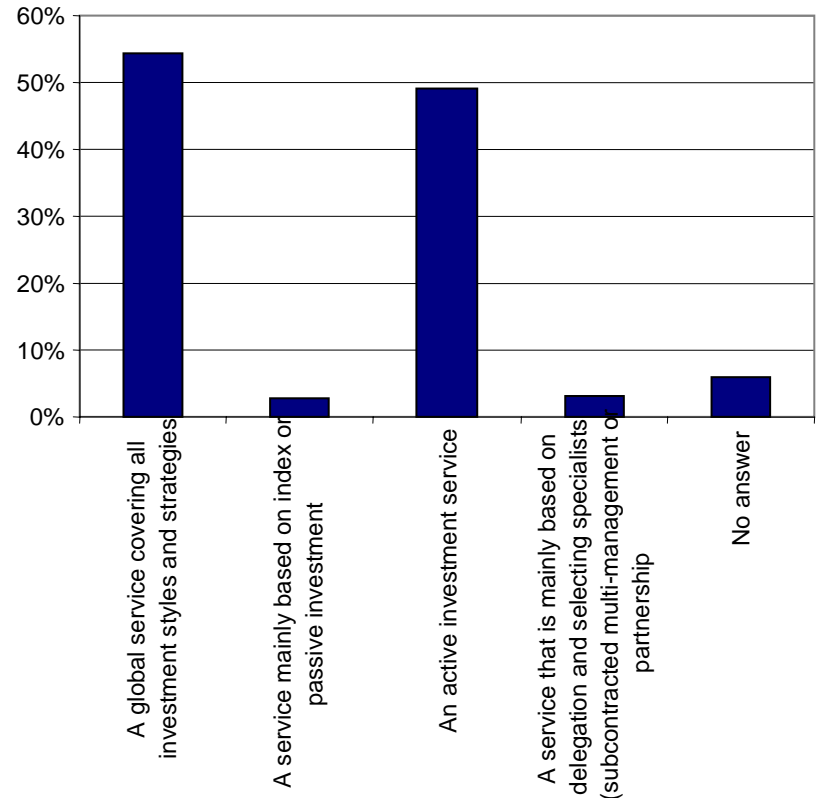
- 60 asset management firms responded to the survey;
- AUM of respondents totals 6,211.62 billion Euros;
- The structure of the sample is very similar to the structure of the whole survey population;
- The number of responses allows for a pan-European analysis;
- Comparisons between countries should be considered with care.

The management offerings

Global or niche offering

- Most asset management firms position their offering as global offers, whatever their size;
- Strategic thinking on the question of critical size has not yet had a dramatic impact on the market.

How would you best describe the investment services proposed by your company?



The management offerings

Active vs Passive

- Development of passive offerings
 - Passive offerings represent 23% of “Equity” products and nearly 10% of all products;
 - These results are consistent with other market analysis (Morgan Stanley, Watson Wyatt)

Country	France	Germany	UK	Others	Europe
Index Management - Equities	3.18%	4.25%	13.06%	11.55%	9.89%
Index Management - Bonds	2.06%	0.75%	0.45%	4.97%	2.29%
Active Investment - Equities	36.25%	27.95%	46.40%	25.85%	35.45%
Active Investment - Bonds	36.42%	45.66%	29.00%	33.09%	33.65%
Multi-Management - Traditional	0.53%	2.50%	1.73%	7.54%	3.64%
Multi-Management - Alternative	0.86%	1.25%	0.00%	0.60%	0.50%
Alternative Investment	1.16%	1.25%	0.88%	1.06%	1.03%
Currency overlay	0.12%	7.64%	0.00%	1.26%	1.41%
Private equity	0.00%	0.00%	0.81%	0.58%	0.50%
Money market Investment	17.22%	3.00%	3.87%	9.23%	7.69%
Others	2.35%	5.75%	3.79%	4.30%	3.98%
No answer	28.57%	0.00%	0.00%	2.08%	8.57%

The management offerings

Active vs Passive

- The drivers for the growth of passive offerings:
 - Active products seen as too passive, too close to indices => what justifies the fee premium ?
 - Current difficulties of “Stock Picking” approaches in the “Long Only” universe;
 - Cost of portfolio turnover not always offset by an enhanced risk/return profile (cf. Fitzrovia study 2003)

The management offerings

New forms of organisation: core-passive/active-satellite

Organisation of “core passive – active satellite” allocation:

- Clear separation of a major portfolio (core) managed passively from one or more very actively managed satellites;
- Approach tightly linked to the development of ETFs;
- Approach favoured by consultants for cost reasons.

The management offerings

New forms of organisation: core-passive/active-satellite

- Favoured by consultants for performance reasons:
 - Allows for a better distinction between good and poor performers
 - Allows for manager diversification in the satellite portfolio
 - Ease the risk management process, a 20% tracking error limit is easier to respect than a 4% limit
- The core-satellite approach can result in a new segmentation of management offerings:
 - Core-satellite assembler
 - “Core” producer or “Beta” factories
 - “Satellite” producer or “Alpha” specialists.

The management offerings

Multi-management

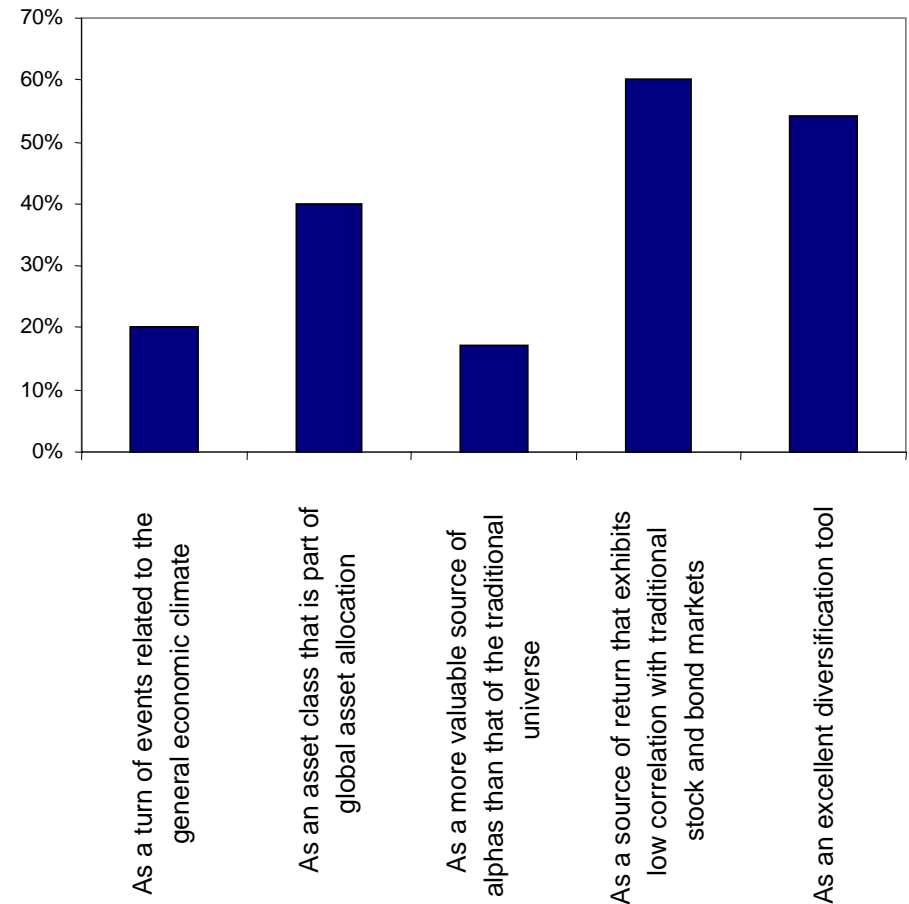
- Despite its popularity and success, multi-management only represents 4.14% of the existing offerings;
- Alternative multi-management is barely present with 0.5% of responses;
- Funds of funds represent the most popular way of implementing multi-management offerings (46% of responses)

The management offerings

Alternative Investments

- A diversification approach rather than a quest for out-performance
 - Only 17% of respondents mention the superior “alphas” of AI
 - 60% of respondents put forward the diversification and de-correlation properties of AI.

Perception of Alternative Investments



The management offerings

Alternative Investments

- The development of Alternative Investments favours outsourcing
 - Acceptance of the specifics of this form of management, including for alternative multi-management
 - The low level of volumes does not justify internalisation of the activity.

Implementation of alternative investment services

With a subsidiary company or a department within the asset management firm	37%
With the investment bank of the group the asset management firm belongs to	11%
With an external organisation	31%
No answer	31%

The management offerings

Structured products

- Structured management is perceived as a strategic offering for 34% of respondents and of interest for 31%.

Do structured products play an important part in your company's strategy for the future?

Country	France	Germany	UK	Others	Europe
Yes	57%	0%	25%	42%	34%
No	0%	50%	50%	25%	31%
Of some interest	29%	50%	25%	33%	31%
Don't know	14%	0%	0%	0%	3%

The management offerings

Structured products

- Structured management does correspond to a more significant need for “risk profiling” from investors
 - Managers have to be able to manage the different moments of return distributions (especially the symmetry and extreme losses);
 - The use of derivatives appears as a new source of added-value;
 - The UCITS III directive should allow for “risk profiling” based on derivative instruments.

The management process

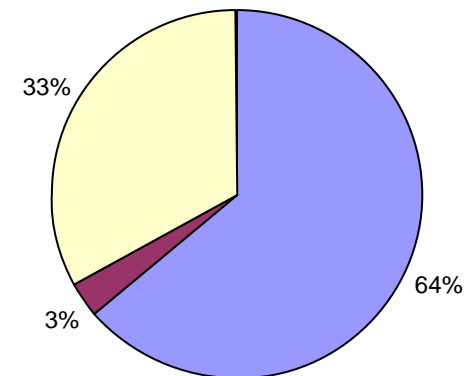
Asset allocation

- United Kingdom and Europe
 - Active asset allocation is favoured in the management process for all European countries, with the exception of United Kingdom (Investment Bank / Broker-Dealer culture)

Country	France	Germany	UK
A top/down approach separating the strategic and tactical allocation phase from the stock picking stage	100%	75%	37%
An opportunistic approach based on stock selection without reference to a process or to asset allocation constraints	0%	0%	0%
A bottom up approach based on stock selection with allocation constraints	0%	25%	63%

Percentage is established based on number of responses, eleven percent of respondents did not answer this question

Which investment process do you favour? (Europe)

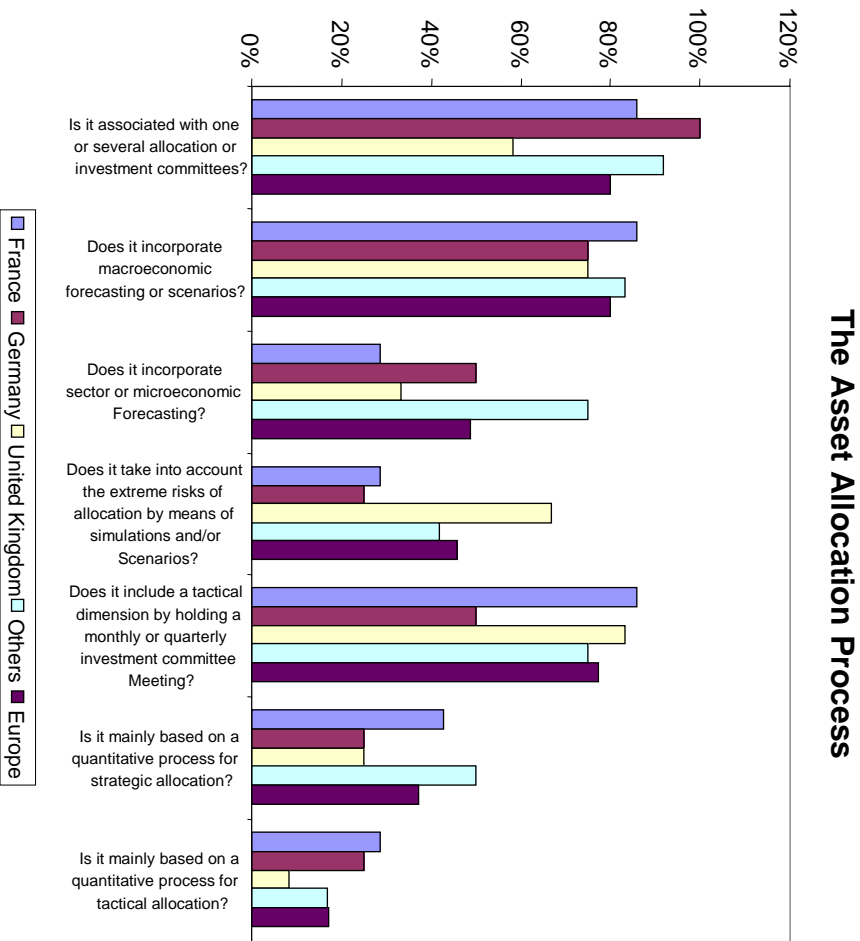


- A top/down approach separating the strategic and tactical allocation phase from the stock picking stage
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The management process

Asset allocation

- Tactical allocation is widely used by asset management firms
 - The allocation privileges macro-economic forecasts (80%);
 - Despite academic results, quantitative approach for tactical allocation is not widely used (17%), with investment management firms preferring a qualitative approach.

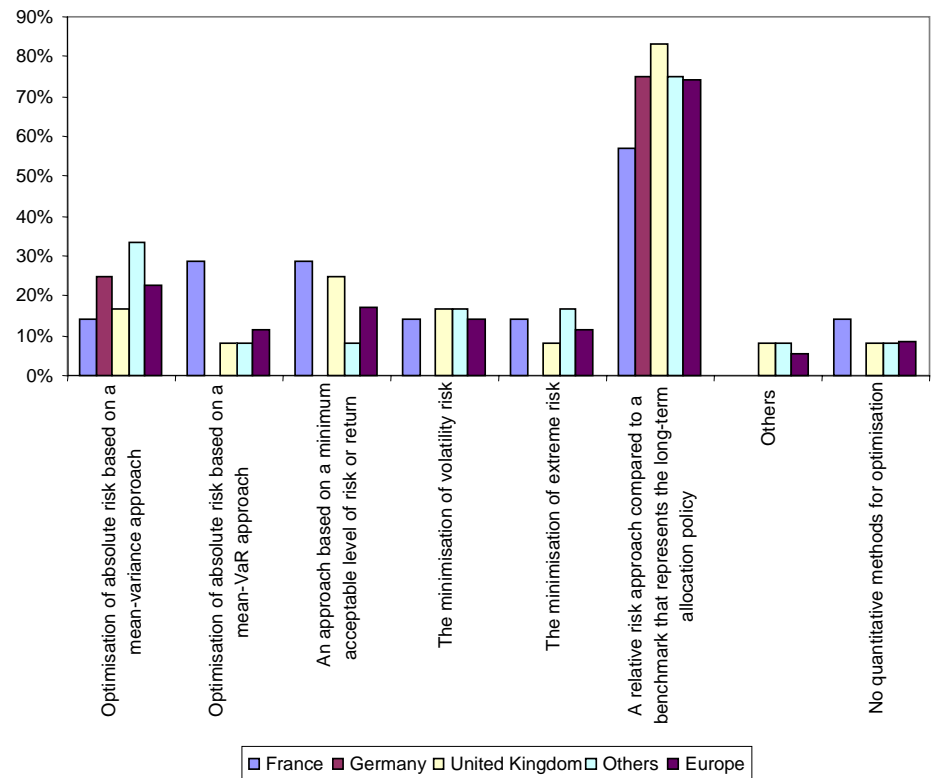


The management process

Portfolio construction

- The benchmark relative risk approach is favoured by respondents (74%)
 - This approach is usually supported by a Black & Littermann approach which compares the market portfolio (neutral view) to a market capitalisation weighted index.

Is portfolio composition for one or more asset classes, categories or styles based on:



The management process

Portfolio construction

- Despite its weaknesses, 23% of management firms use the mean-variance approach;
- Only 22% of respondents take extreme risks into consideration in the portfolio construction process.

Performance analysis

Risk-adjusted measure

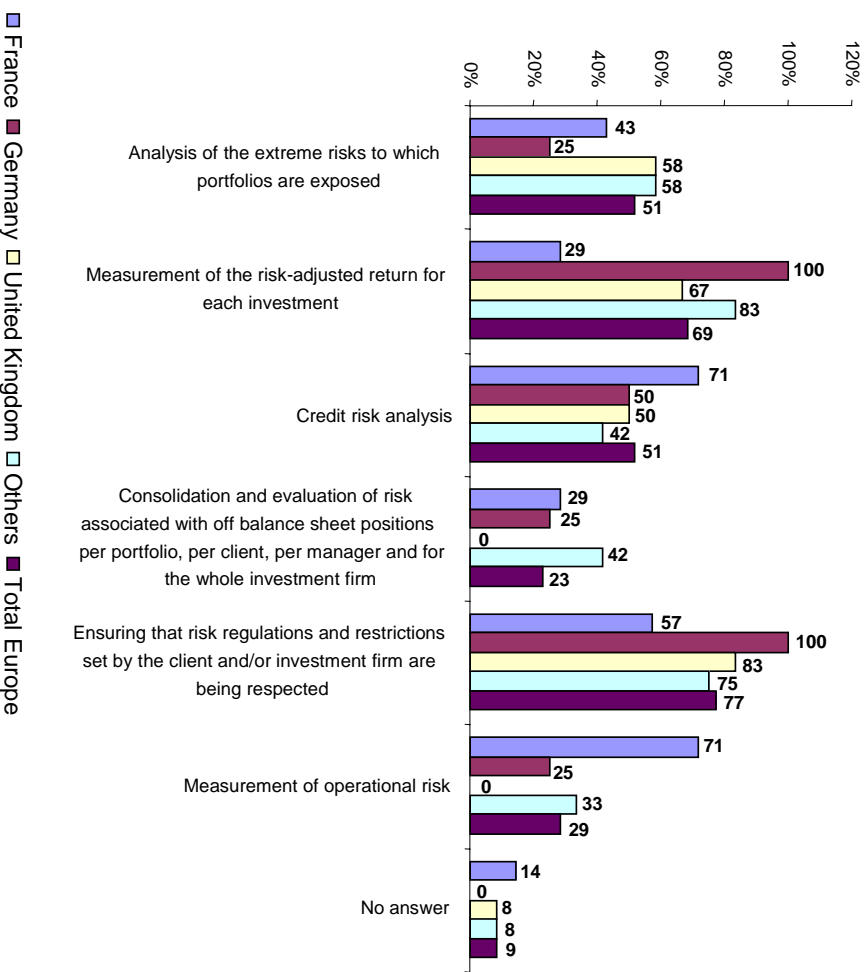
- An unsophisticated approach to measuring managers' alphas
 - Low level of usage of multi-factor models (17%)
 - General use of Peer Groups (51%)
 - Measurement of out-performance with regard to a benchmark (97%)
- The benchmark is usually a market index (97%) and rarely a normal portfolio representing the true risk exposures of a portfolio over the period (6%).

Risk management

Risk monitoring

- The measurement of risk as required by the regulator or the mandate is a key constituent of the risk monitoring function;
- Only 51% of respondents monitor the portfolio's extreme risks;
- Only 23% of respondents consolidate and assess the risks of off-balance sheet operations.

Which of the following does risk analysis include?



Risk management

Future investment

- Investment priorities are consistent across the various geographical zones:
 - Management of allocation constraints and risk limits (60%)
 - Measure and analysis of extreme risks (46%)
 - Evaluation and monitoring of off-balance sheet positions (52%)
- It is also interesting to note that client reporting is widely seen as a key investment (71%)

Risk management

Risk measurement

- Two types of risks are not well represented:
 - Volatility risk (56%), for which the score is probably linked to the low usage of derivative instruments. France is an exception with regard to this question;
 - Liquidity risk (59%), for which the challenges are both conceptual (definition of a model for measuring liquidity risk) and technical (implementation of the consequences of liquidity risk on instrument pricing) (cf. CMRA study, 2001).

Risk management

Value at Risk (VaR)

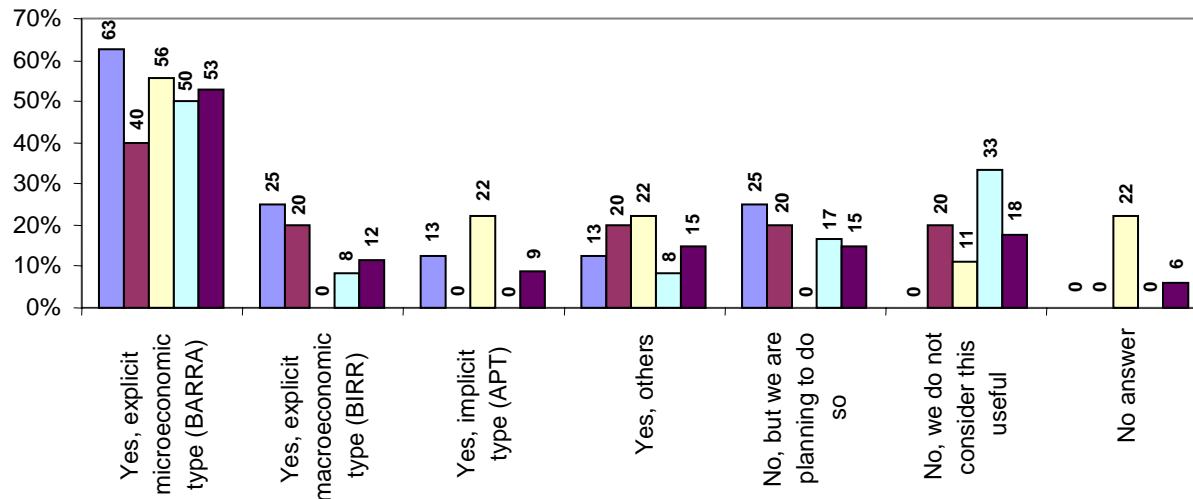
- Usage not widespread (51%)
 - No regulatory framework;
 - The systematisation of VaR requires the adaptation of complex tools initially designed for investment banking
- Need to adapt the VaR calculations to the specific context of investment management firms (simple calculations but real inclusion of non-Gaussian risks)
 - VaR Cornish Fisher (Favre Galinao, 2000)
 - Style VaR (L'habitant, 2001)

Risk management

Multi factor analysis

- Factor Analysis is one of the areas where asset managers have invested the most so far. The usage of multi-factor models is consistent with the “risk relative” asset allocation approach.

Do you base your portfolio risk analysis on a multi-factor model?



Risk management

Multi factor analysis

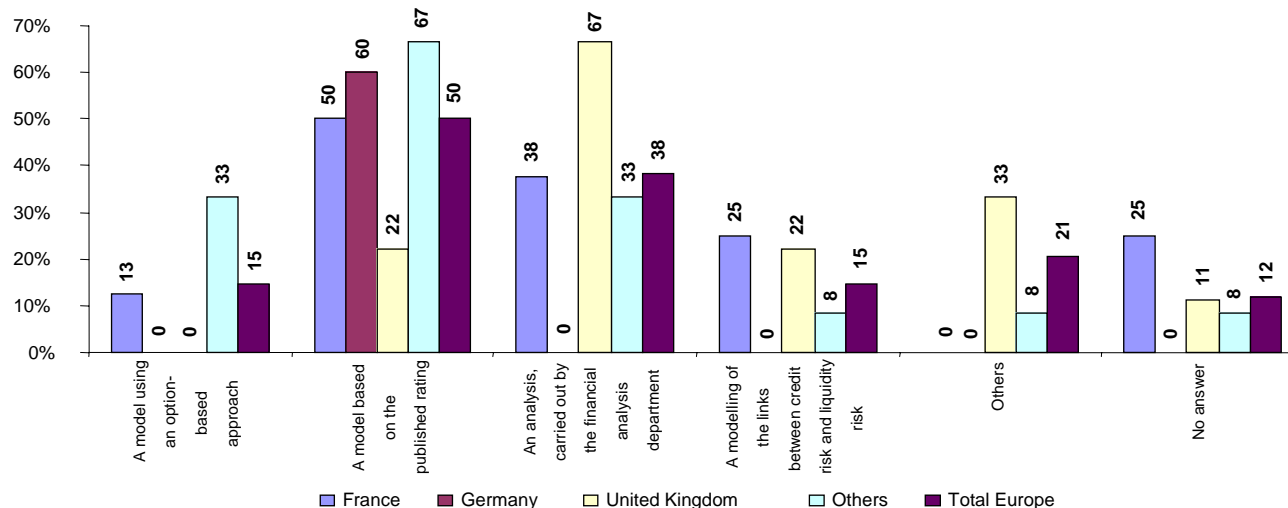
- Even though explicit models (BARRA, BIRR, etc.) still dominate the market, the implicit approaches are growing in importance (9% in Europe and 22% in the United Kingdom).

Risk management

Credit risk

- Quantitative approach not well represented;
- Financial analysis privileged despite its “backward looking” approach.

Is the specific approach to credit risk based on:



Risk Management

Compliance: Level of compliance

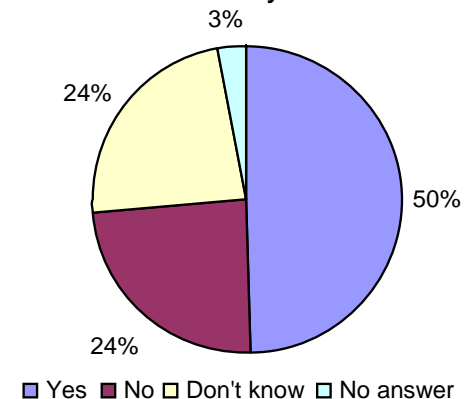
- The level of compliance is quite high so far due to regulatory evolutions;
- Increasing importance of “contractual” compliance;
- Implementation of financial constraint monitoring (VaR 53%, risk factors 24%).

Risk Management

Operational risk: What attention is given to Operational Risk ?

- Only 50% of European management firms feel impacted by the consequences of Basel II, despite the CAD III initiative;
- This lack of interest can be understood:
 - Investment Management companies are not the most exposed to operational risks (custodian role);
 - The implementation of new capital requirements to cope with an idiosyncratic risk is not supported by academic research, nor is it supported by industry studies (Oxera 2001, Biais et al., 2003);

Do you think the Basel II Accord, which allows for the allocation of share capital to cover operational risks of banks and their asset management subsidiaries, will affect your activity?



Risk Management

Operational risk: Measures taken to respond to the new regulatory requirements

- Despite their usefulness with regard to capital savings, internal models have not yet received attention from our respondents;

Country	France	Germany	UK
Yes	0%	20%	0%
No	0%	0%	22%
We have not examined the issue yet	100%	80%	78%

- Loss data collection is the current priority for investment management firms (53%). By definition, however, the data collection cannot serve as a basis for analysing extreme risks, which are supposed to be covered by capital charges. As a result, the question of operational risk is tackled from the operations efficiency angle.