

Lazard Insights

Conference Call Series

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Summary

Dynamic Allocations

A More Flexible Approach for a More Complicated World

The History of Categorization

We look at the history of asset allocation as a series of attempts at categorizing global capital markets along various axes. In the early 1900's, investment in the United States and Western Europe consisted largely of domestic equity, debt, and cash. Capital controls, fixed rates of exchange, high costs of transportation, and limited access to the means of communication restricted investment to the national (and in many cases even the municipal) level. As we all know, the century that followed would see waves of technological, theoretical, and economic advancement. Each wave carried a wider range of investment opportunities to a wider range of investors.

One of the consequences of this horizontal expansion was the set of classifications that the industry iteratively imposed on capital markets. As the number of investment choices broadened, classification systems were created to incorporate—and

sell—these new investment categories to a lengthening list of potential customers, as illustrated in Exhibit 1.

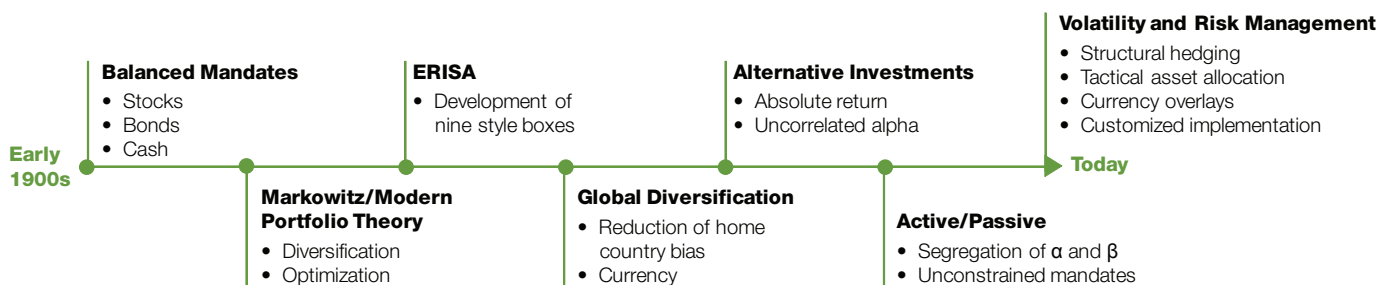
What began as the simple bifurcation of stocks and bonds based on the capital structure of the world's largest firms evolved into a complicated taxonomy as elaborate, arbitrary—and in our opinion as arcane—as the Dewey Decimal System. Whether this trend has been the result of actual investor demand or long-term marketing efforts, it has had a significant impact on the field.

The Evolution of Skills in Asset Management

As classification evolved, the number of investment professionals in the world expanded commensurately, and professional specialization began to form around the categories, as can be inferred by the number of members of the CFA institute, which has increased almost 60-fold over the last 60 years.¹ Although hardly scientific, we would consider

Exhibit 1

The History of Categorization



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this information at least directionally accurate in making the broader point: as the industry has become more complex, knowledge has become necessarily more specialized into an increasing number of sub-categories. A century ago, the idea of an investment professional focused exclusively on cross-over credit in the United States would have been thought of as overkill; today there are thousands of such specialists, whose expertise is not just important, but arguably essential to the smooth functioning of capital markets.

The Evolution of Asset Allocation

The last 100 years have largely been spent categorizing assets. At present, largely inspired by the outcomes of 2008, the industry is going through a period of reclassifying assets again, to more accurately reflect the clusters of today's investors' needs. The future state of this evolution, in our opinion, will be a departure from categorization altogether, and we will undergo what we call de-categorization.

We are seeing more risk-driven categories, new asset classes being carved out of emerging markets, and investment themes around inflation or deflation protection. We can look to the world of ETFs to elucidate this phenomenon. The first ETF was launched in 1993, and now there are over 2,000 ETFs available to investors, each in some way an attempt at re-categorization. There are ETFs that invest exclusively in listed nanotechnology or solar energy companies, for example.

An example of de-categorization can be found in our collective experience with the Internet over the last 15 years. During the early days of the web, sites were found in directories defined by categories: business, sports, etc. To find what you were looking for, you would have to click through a hierarchical folder structure several times. The problem was that one website could fit correctly into many possible categories. Then along came the search engine, which left everything in one large category and allowed to search for websites based on characteristics, down to actual text. In our opinion, the investment management industry will eventually adopt such a structure. As David Weinberger points out in his 2007 book *Everything is Miscellaneous*, classification is a limitation of the world occupied by physical objects like books or cutlery.² In the physical world, an object can only exist at one place at one time. Investment strategies, however, are not bound by those constraints. In this way, investment is more like the web than a library. A portfolio is simply a curated collection of investment ideas, the merit of which is determined foremost by the particular skill of the curator, not some arbitrary category into which the ideas could be bucketed.

Areas of Expertise in Asset Management

Exhibit 2 lists some of the specialized skills that we find in our industry and juxtapose them to some of the traditional boxes or asset classes; a one-to-one mapping between skills and these boxes is a futile exercise. The reality is that the skills of an investment professional (or collection of investment professionals) might be present in all boxes, but they are not defined by the boxes themselves. Expertise (or a lack thereof) transcends asset class boundaries.

Exhibit 2 Skills transcend asset class boundaries

Skills	Asset Classes/Boxes
<ul style="list-style-type: none"> • Position sizing • Factor modeling • Data analysis • Accounting expertise • Interpretation of financial statements • Expertise in interview management • Identification of investment themes • Cultural and language expertise 	<ul style="list-style-type: none"> • U.S. large cap equity • U.S. small cap equity • European equity • Emerging markets equity • U.S. fixed income • Global fixed income • Commodities

Defining Client Needs

We believe that one reason why assets are so haphazardly classified is because we spend too little time defining objectives and too much time comparing results. Results need a common basis of comparison; that common basis, which usually revolves around benchmarks, reinforces the walls that keep investments in boxes.

But the trend that has emerged in the last three years appears to reject that conventional wisdom. Investment mandates are increasingly attempting to define the buckets by the skills available: a solution to the inflation dilemma or a means of capitalizing on GDP growth in emerging markets, for example.

By skills here we are not referring to one investment professional, but to the set of skills collectively held in one platform or organization. Earlier, we referred to a portfolio as a curated collection of ideas—in much the same way, an investment platform is a curated collection of skills. Therefore, what strategies are part of that solution, and the allocation to those strategies at different times, depends on how the solution is built and what the expertise of the manager is. It makes the

manager more accountable than a narrowly defined benchmark can.

Dynamic Allocations

“Dynamic” allocations refer to customized allocations built around investment competencies and not conventional asset class buckets. However, the term “dynamic allocation” is somewhat ambiguous, and can mean different things at different firms. For us, dynamic allocation means that an investment manager is given a mandate to invest in more than one investment strategy, and is accountable not only for the performance of each strategy, but also for the allocation among the strategies.

The first step, then, is to clearly define the skills relevant to the specific investment problem at hand. The next step is to clearly define the breadth of skills that each manager possesses. The tools available to the end investor do not need to be defined by traditional buckets. The new “buckets” are as wide as the competencies of the investment teams...but no wider. These buckets will overlap; firms will be cleanly distinguished. However, this approach does not require the interim step of first aggregating skills into buckets, then disaggregating the buckets to determine skills, and it attempts to pair client objectives directly with expertise—a subtle difference perhaps, but one with broad potential consequences.

Once the specific objectives have been paired with available skills, the last step is to create a mandate that crosses one or more existing investment strategies. This is the step that adjusts for the fact that skills are classified along different axes compared to objectives—a typical mandate has a benchmark,

but benchmarks are objectives and are not bound together by anything.

By explicitly crossing one or more of the borders of skill, this kind of mandate holds the manager accountable for allocating between its internal areas of expertise and keeps the focus on objectives rather than benchmarks. Otherwise, a single strategy that outperforms its benchmark would be considered successful, regardless of what happens to the relationship between a benchmark and the client objectives.

Dynamic Allocations - An Example

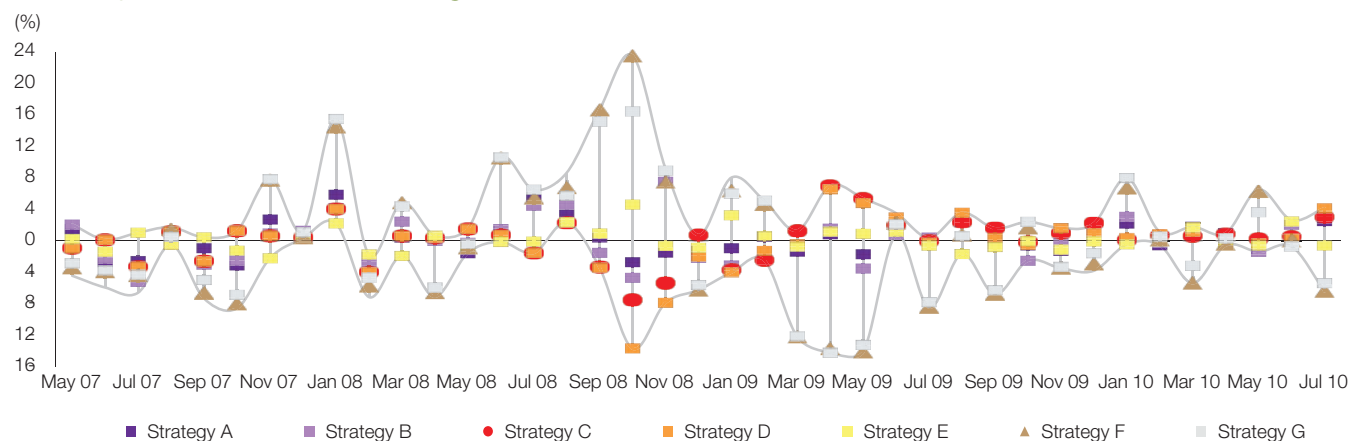
An example will help to illustrate the point. Exhibit 3 shows the results of seven different strategies with seven distinct sets of investment expertise from within the same firm, all in the same broad asset class. While these are actual results, the names of the strategies, firm, or even the asset class do not really matter here. What is relevant is that the dispersion of monthly outcomes is very wide.

Although any one of these strategies could be described as beating its respective benchmark, the applicability of any one strategy to a specific set of objectives varies over time. Strategy F appears to have been appropriate during periods of high volatility, whereas Strategy C appears to be appropriate for periods of low volatility. If we have reason to believe that this characteristic comes from the expertise of the manager, we would want to switch from one to the other as the environment changes.

Many investors would like to be able to do this in theory, but the mechanisms of changing the allocation in accordance with the prevailing context are not readily available in prac-

Exhibit 3

Relative performance of 7 strategies within the same firm



tics. Consultants and investment committees set long-term, strategic asset allocations, which line up with investment objectives, but the speed at which they can react to changes in environment are limited by practical considerations, like quarterly meetings or the cycle of manager due-diligence. Whereas the broader, strategic global asset allocation might be tailored to the objectives, the underlying components are not. Dynamic allocation that explicitly makes the manager choose between types of skills can go a long way towards solving this incongruity.

Analysis of the Economic Context

How then, might a manager measure the investment environment? In our example in Exhibit 3 we looked at volatility, but a one-factor model alone is insufficient.

First and foremost, an assessment of the economic context should use multiple metrics. Not all these metrics are

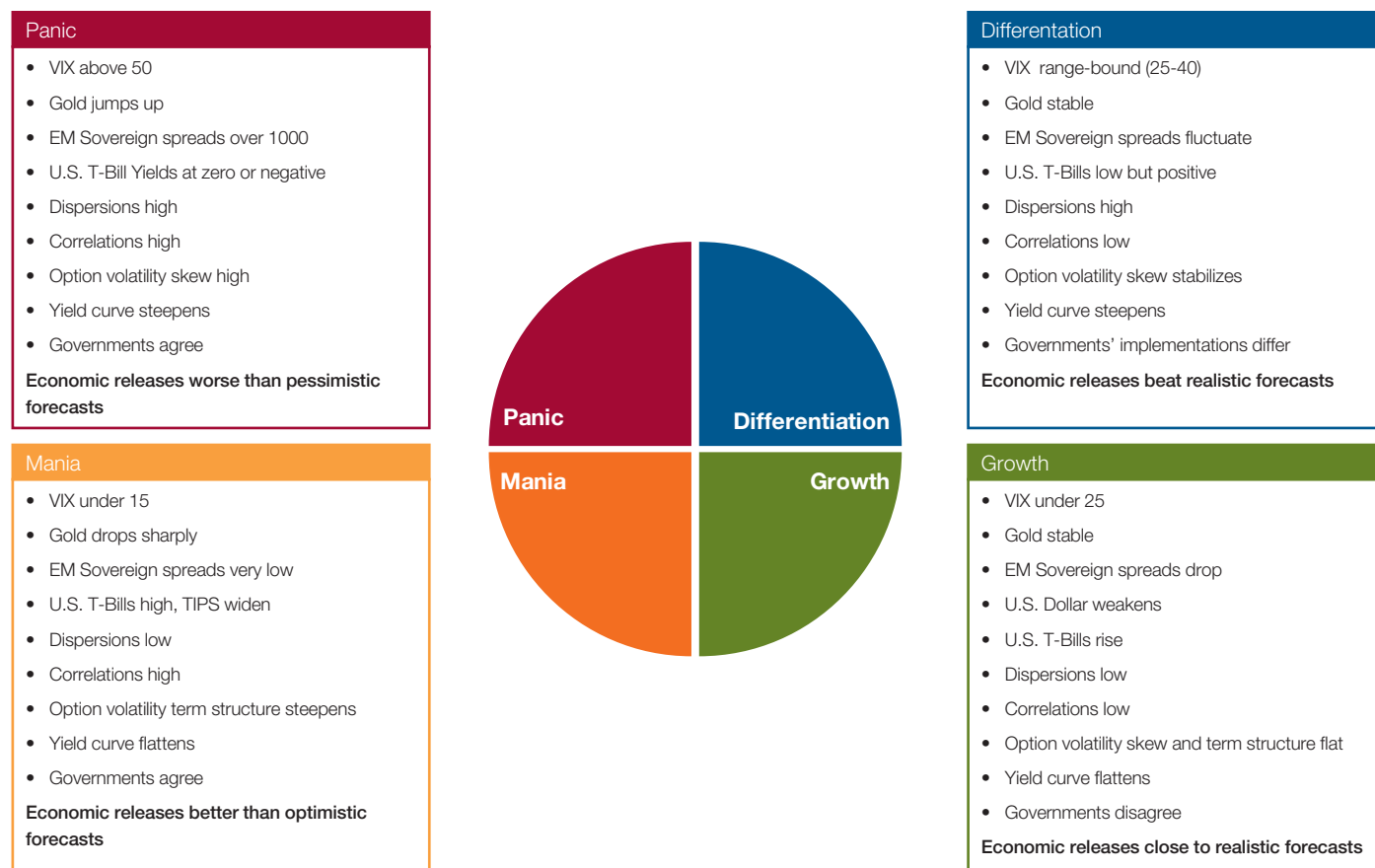
quantitative in nature. To paraphrase Hayek, not all of the factors that are important are those that are easy to measure. Consider central bank independence, or the long-term viability of an authoritarian regime. These are factors that are, by their very nature, qualitative and rely on the subjective weighting of certain scenarios.

Finally, the metrics change. Balance sheets and cash flow statements have a reasonably static list of numbers that the industry uses to understand a company. The numbers change, of course, but the column headers do not. This is not the case with the broader economy. One day, the TED spread is in the headlines, and two years later it is relegated to obscurity. The macro numbers change, but the column headers change as well.

Exhibit 4 illustrates a subset of some of the factors that we might look at. Everyone will have a different way of looking at the economic context, each with various merits and

Exhibit 4

Analysis of the Economic Context – An Example



drawbacks. In this case, we modeled a few dozen factors and had them contribute to one of four broad economic contexts, resulting in a probability-weighted estimate of what the investment environment is. In practice, such a model should be overlaid with qualitative research, but our purpose here is not to get into the weeds of macro modeling.

Making Decisions Based on a Changing Economic Environment

Exhibit 5 shows that this approach—like any approach—results in changing economic contexts over time. As these changes occur, a set of skills will be of varying applicability. If an allocation is locked into a single type of manager skill, there will come a time when the wrong skills are being brought to bear on a set of investments. A more flexible approach—a dynamic allocation, whereby the mandate allows for more than one set of skills to be deployed according to the applicability of those skills—means that the solution will be more aligned with the objectives at more than just the strategic level.

Potential Pros and Cons of Dynamic Allocations

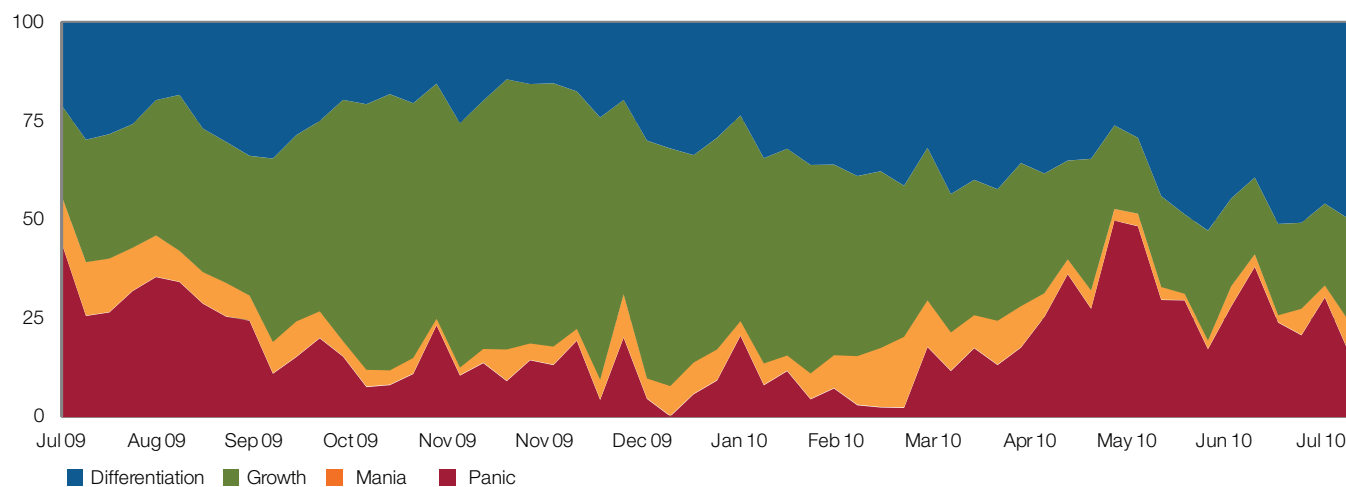
First and foremost, knowledge of the expertise is one of the pros of dynamic allocations. Once a fiduciary responsibility for self-awareness falls on the manager, no one is in a better position to understand the strengths and weaknesses of a firm than the firm itself. A firm has access to its own data and reviews its own people every day. These kinds of mandates are designed to use that information.

Timeliness is another advantage, as we discussed earlier—the investment environment does not wait for quarterly meetings to change. Another benefit is the matching of expertise with the environment: this comes down to a firm knowing its strategies' strengths and, more importantly, its strategies' weaknesses. As we discussed, customization—another benefit—starts by deliberately imposing a classification system reflective objectives and not industry conventions. Finally, accountability is what ties these advantages together.

The risks to this kind of mandate are equally important. A departure from the traditional boxes means success or failure is more difficult to measure. Just as the objectives need to be well defined, so too must the definitions of victory or defeat. Single-firm risk is also a drawback to the extent that an investor goes to the same firm with many problems. However, we would submit that there is no single firm with the breadth of expertise to solve all investment problems, so multiple investment objectives can mean several of these mandates, each to investment firms with appropriate expertise.

Another major risk is conflict of interest. This can come in several forms. The most common happens when the set of skills that seems most appropriate happens to always be the most expensive of the set of skills offered. There are many ways of dealing with this issue, but we believe it is always something to be keenly aware of with any customized mandate.

Exhibit 5 The Changing Economic Context



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Notes

- 1 Source: CFA institute (National Federation of Financial Analysts Societies from 1947 to 1961; then Financial Analysts Federation from 1961, together with the Institute of Chartered Financial Analysts from 1959 to 1990; Association for Investment Management and Research from 1990 to 2004)
- 2 David Weinberger, "Everything is Miscellaneous," 2007

Important Information

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