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# Freeing Intellectual Capital: The Case for Unconstrained Global Equity Investing

## WHY INVEST GLOBALLY?

The geographic debate that once confronted U.S. investors centered solely on the allocation between domestic and international markets. But, as developing economies such as China rose to prominence on the global economic stage, the decision as to how much to allocate to emerging markets entered the equation. The geographic debate has now evolved to the point where, in a globally integrated economy, constructing a portfolio from one global universe, rather than splitting a portfolio by geographies, arguably seems the most logical approach. Why?

One of the primary objectives of an investor is invariably to generate the best possible risk-adjusted returns over time. If this premise is accepted, then restricting the universe of opportunities available to investors undermines this principal objective. Historically, the presence of illiquid and ill-regulated foreign markets, coupled with the difficulty in obtaining reliable and timely data on overseas investments, may have dissuaded investors from looking beyond domestic markets. We believe these issues no longer serve as barriers to overseas investment. Most developing markets today offer foreign investors adequate liquidity and sufficient regulatory and legal comfort. Meanwhile, modern communications bring instant, real-time market information to investors across the globe, typically at relatively low cost.

We believe there are two key benefits from a global approach to investing: the breadth of the opportunity set and the pursuit of “best ideas.” The information ratio, which measures a portfolio manager’s ability to generate excess returns relative to a benchmark, is essentially a function of skill and breadth. If an investment manager’s skill is constant, then, in theory, the more breadth or flexibility is provided to a manager, the higher is the information ratio, given the greater number of investment opportunities available.

The “best ideas” notion reflects the fact that an investor with separate regional portfolios is effectively beholden to multiple, separate benchmarks. A commonly cited example resides with the automotive industry. If an institutional investor employs a dedicated U.S. equities manager, a dedicated international equities manager, and a dedicated emerging markets equities manager, the investor may own at least three auto stocks in the overall portfolio because of each investment manager’s ties with their respective benchmark. In contrast, a global manager is free to select what they feel is the most attractive opportunity in the automotive sector, or, indeed, if unconstrained, none at all.

As well as ensuring access to strong investment opportunities in the world’s capital markets, global investing not only offers tremendous diversification benefits across sectors and industries, but also by countries and thus economies, stock markets, and political systems.

## WHAT IS UNCONSTRAINED INVESTING?

Unconstrained investing refers to a portfolio management approach where the investment manager does not make reference to a benchmark index in the construction and management of a strategy or portfolio. With an unconstrained approach, portfolio managers build and manage the portfolio in a manner that fully reflects their investment view; they are unhindered by restrictions such as stock and sector limits that are fixed with reference to a benchmark index. This freedom afforded

to the investment manager is the reason why the unconstrained approach is also sometimes regarded as “best ideas” investing.

The arrival of the 21st century brought with it wide declines in global equity markets. The bear market that concluded in March 2003 led liability-focused investors to reconsider their thinking and place a much greater emphasis on absolute performance rather than performance relative to an index. This resulted in increased interest in unconstrained products, as investors, with an eye on their liabilities rather than relative performance versus an index, sought out products that provided a greater opportunity to meet these liabilities rather than simply outperform in falling markets.

## **THE RISKS OF BENCHMARK INVESTING**

The retrospective nature of indices does not account for the notion of creative destruction, popularized by the economist Joseph Schumpeter, which resides at the heart of capitalism. Central to this concept is the idea that innovation by entrepreneurs is the force that drives the long-term growth of economies, even as it destroys the value of established companies. Companies that once dominated an industry can soon fade from memory, as new entrants with new products, new technology, or new methods of distribution undermine the previous incumbents.

Critics of benchmark-driven investment liken the use of benchmarks in the portfolio construction process to driving solely using one’s rear-view mirror; benchmarks tell you a lot about where you have come from, but nothing about where you are going. Benchmarks, by their nature, they argue, reflect the successes of the past; those companies and industries that have prospered and grown over time are captured by the benchmark, whereas more dynamic, future challengers to industry dominance may well be significantly under-represented in an index.

One of the charges sometimes leveled at benchmark-focused managers is that of “benchmark hugging.” Benchmark hugging occurs when a supposedly active manager effectively shadows a benchmark index so closely that the performance of the portfolio closely mimics that of the index. Active managers guilty of benchmark hugging only take very small active positions relative to their benchmark index and, quite possibly, own stocks that they find unattractive in proportions similar to that of the index. Even when such managers make a good decision, the outperformance generated may be negligible relative to the market return. The charging of active management fees for effectively passive management performance, as has been the practice of some supposedly active managers, is an argument in favor of unconstrained investing. Benchmark-focused constraints, such as tight tracking error restrictions, maximum relative position sizes, and peer performance reviews, can all encourage benchmark-hugging behavior. Jettisoning the benchmark self-evidently prevents the phenomenon of benchmark hugging.

Stock and sector weightings within a benchmark can also present risks. Benchmarks tend to have a high concentration in large- or mega-cap stocks, whose performance may vary depending upon what point it is within a market cycle. An example of a highly concentrated index is the United Kingdom’s blue ribbon FTSE 100 Index. Here, the ten largest stocks by market weight account for almost half of the index.

Strong performances by sectors over time can also lead the sector composition of indices to become heavily skewed. The S&P 500 Index offers a good example. Today, the information technology sector accounts for 16.5% of this index. Yet at the end of 1999, just before the bubble in so-called TMT (technology, media, and telecommunications) stocks burst to devastating effects, the information technology sector accounted for almost one third of the index. At that time, portfolio managers employing a benchmark-focused investment strategy with tracking error constraints would have struggled to avoid the technology area, even if they felt that the sector was highly overvalued, as proved to be the case.

## **RISK MANAGEMENT IN AN UNCONSTRAINED WORLD**

Given the preponderance of benchmark-driven global equity strategies, it is understandable that, for risk management purposes, the absence of a benchmark can cause unease in prospective investors considering an unconstrained equity strategy. The starting point for many professional equity investors in describing the riskiness of their portfolios is their stated tracking error target, the widely recognized means by which long-only equity investors quantify their appetite for risk. A low tracking error, i.e., where a portfolio’s returns deviate little from those of the benchmark index, is broadly interpreted as a

low-risk investment approach; a high tracking error is generally accepted as being indicative of more risk taken by a portfolio manager or investment team.

Without a benchmark, the risk focus switches away from the notion of relative volatility to the concept of absolute volatility: how volatile are the returns in isolation over time? Unconstrained equity portfolios may prove to be more volatile than benchmark-focused portfolios, especially if they contain a relatively small number of stocks. Nevertheless, if the portfolio manager's best ideas prove to be particularly good at preserving capital in a falling market, then the portfolio's absolute volatility may prove to be lower than that of the benchmark index.

## **CONCLUSION**

Unconstrained global mandates allow investment managers the latitude to scour the world to identify strong investment ideas. Free from benchmark-related constraints that may compel them to invest in sectors or countries they find entirely unappealing, the unconstrained investor can focus on investment opportunities that will help preserve and grow capital.

This is not to overlook the important role played by benchmarks in the portfolio construction process for the bulk of Lazard's investment strategies. Not only is a well-chosen benchmark a suitable yardstick by which to measure a portfolio's performance, it can help to ensure sufficient diversification by market capitalization, industry, sector, country, and region.

At Lazard, we offer a range of unconstrained global equity investment strategies. In each instance, our portfolio management teams have the freedom to pursue the most compelling investment opportunities, regardless of geography and benchmark ties. For investors comfortable with investment processes that do not use a benchmark to help frame the portfolio construction process, Lazard believes that a global unconstrained equity portfolio is the ultimate means of allowing long-only investment managers the freedom to follow their highest conviction investment ideas.

## **NOTES:**

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