

Pensions & Investments. April 14th 1997.

The logo for Global Wealth Allocation (GWA) features the letters 'GWA' in a white, serif font, positioned within a dark blue circular arc that curves from the top left towards the center.

Global Wealth Allocation

Building Portfolios without Prices

david.morris@globalwealthallocation.com

A NEW LOOK IN BENCHMARKS: CONSULTANT DEVISES ALTERNATIVE BASED ON COUNTRY WEALTH

By Joel Chernoff

LONDON - A U.K. consultant has devised an international benchmark that, it claims, succeeds where the U.S.' capitalization-weighted and U.K.'s consensus-driven approaches fail.

The difference is that John Morrell & Associates' new Strategy Index establishes a forward-looking neutral portfolio. Existing benchmarks reflect backwards, rewarding those markets that have performed the strongest in the recent past, said Mr. Morrell, a former chairman of Barings International Investment Ltd.

This backwards-looking approach encourages managers to buy high and sell low, he said.

Problems with existing benchmarks have become apparent in both U.S. and U.K. pension markets. Japan's huge weighting in the cap-weighted Morgan Stanley Capital International Europe Australasia Far East Index has perplexed U.S. pension executives and international managers for years.

The degree to which managers have weighted Japan - which in EAFE has reached as high as 61% in February 1989 - has spelled the difference between out- and underperformance. Many U.S. pension experts have tried to address this issue by, for example, halving Japan's weighting in their benchmark or adopting a benchmark weighted by gross domestic product.

Mr. Morrell said the U.S.-style market-cap-weighted approach is inappropriate for the international arena, where crossborder inefficiencies and currency volatility dramatically affect index weightings.

He also rejects alternative approaches as lacking intellectual rigor or, in the case of the GDP-weighted approach, for overemphasizing markets such as Germany with low levels of publicly traded equities.

Similarly, Mr. Morrell argued the U.K. pension industry has badly missed the U.S. stock market's gains of the past two years because it adheres to the median British pension fund asset mix.

Disclaimer

This information is not provided as the basis of any professional advice or for transactional use. GWA shall not be responsible or liable for any advice given to third parties, or any investment decisions or trading or any other actions taken by you or by third parties based on information contained in this document.

The logo for Global Wealth Allocation (GWA) features the letters 'GWA' in a white, serif font, positioned within a dark blue circular arc that curves from the top left towards the center.

Global Wealth Allocation

Building Portfolios without Prices

david.morris@globalwealthallocation.com

Three factors tend to drive stock markets, Mr. Morrell said: corporate earnings, balance sheets and dividends. The firm comes up with a neutral country weighting based on the proportion of these factors to the total universe.

The firm also then adjusts for purchasing parity power, smoothing out currency fluctuations, which provide a large amount of volatility in cap-weighted benchmarks. In addition, adjustments for cross-holdings are made.

Optional features include adjusting for expected growth rates and for a country's GDP relative to market capitalization.

The result is an index that proves to be far more stable and adds more value at lower risk than the EAFE, Mr. Morrell said.

For the 20-year period ended Dec. 31, the Morrell Strategy Benchmark index has provided an extra 180 basis points on an annualized basis based on the company's backtesting.

The index underperformed in the mid- to late 1980s when the Japanese market was soaring. In February 1989, the index's 19.2% weighting in Japan would have been less than one-third that of the EAFE's 60.9%. But it more than made up for those losses later.

Even when Japan is taken out of the index, the Morrell benchmark still outperforms MSCI's benchmark, said consultant Hugh Davies. For the 10 years ended Dec. 31, the Morrell index ex-Japan returned an annualized 13.8%, compared with 12.9% for the EAFE ex-Japan.

What's more, the international index beats the EAFE with less risk. The standard deviation for the Morrell index is 11.5% and 15.8% for the five- and 10-year periods, respectively, compared with 13.4% and 17.7% for the EAFE.

Active managers can then take tactical bets off of the Morrell benchmark or add tilts that suit their investment style, he said.

Morrell consultants acknowledge many money managers' asset mixes already deviate sharply from the EAFE. Managers "need a justification for what they are doing already," explained David Morse, a consultant.

Disclaimer

This information is not provided as the basis of any professional advice or for transactional use. GWA shall not be responsible or liable for any advice given to third parties, or any investment decisions or trading or any other actions taken by you or by third parties based on information contained in this document.

The logo for Global Wealth Allocation (GWA) features the letters 'GWA' in a white, serif font, positioned within a dark blue circular arc that curves from the top left towards the center.

Global Wealth Allocation

Building Portfolios without Prices

david.morris@globalwealthallocation.com

The firm also has linked up with State Street Global Advisors, Boston, to serve as subadvisor on a passively managed product based on Morrell's global index, which then can be broken into broad international or regional slices. An emerging markets fund may follow later.

While an agreement is close to being signed, several other hurdles need to be overcome. Products should be up and running by the end of June, Mr. Morrell said.

Mr. Morrell sharply faulted investment consultants for leading their pension fund clients astray by adopting formulaic approaches not guided by investment experience.

In particular, he said adoption of passive portfolios - while suited to the efficient U.S. stock market - were inappropriate when investing abroad because of inefficiencies in crossborder markets and volatile currency fluctuations.

Morrell also railed against U.S. "litigant-oriented" investment approaches. The problem is that if a U.S. pension executive is given the choice between increasing performance or reducing risk, "every U.S. institution would reduce risk," he said.

This aversion to risk stems from Nobel Prize-winner Bill Sharpe's labeling of the horizontal axis as risk rather than opportunity - "a fundamental error," Mr. Morrell asserted.

"There is a preoccupation and narrow definition of risk," he said, "that moves people away from capturing opportunities." If risk offers opportunity, that strongly supports active management, he added.

What's more "analysis paralysis," stemming from backwards-looking performance attribution analysis, causes pension executives to react too late, Mr. Morrell added. What's needed is a proper risk management system that anticipates future market moves, he said.

His firm, established in 1992, has an average staff age of 62 - "the Jurassic Park of investment professionals," he joked.

Disclaimer

This information is not provided as the basis of any professional advice or for transactional use. GWA shall not be responsible or liable for any advice given to third parties, or any investment decisions or trading or any other actions taken by you or by third parties based on information contained in this document.

The logo for Global Wealth Allocation (GWA) features the letters 'GWA' in a white, serif font. The letters are positioned within a dark blue, semi-circular shape that resembles a stylized arc or a portion of a globe.

Global Wealth Allocation

Building Portfolios without Prices

david.morris@globalwealthallocation.com

His colleagues include: David McKendrick, former director of IBM Retirement Funds Europe pension chief; Mr. Davies, former principal of Global International (later named Globe Finlay); Mr. Morse, former director of investment at the U.K.'s Water Authorities Superannuation Fund until it was privatized in 1988; and Alex Hammond-Chambers, former chairman of Ivory & Sime, and based in Edinburgh.

Last July, the firm added a younger generation by acquiring the U.K. investment consulting division of Canadian financial services firm Johnson Fry PLC. David Morris, a former group financial controller for Campbell Soup Co.'s U.K. operation, and Ominder Dhillon contributed their technological abilities to the group.

GWA

Disclaimer

This information is not provided as the basis of any professional advice or for transactional use. GWA shall not be responsible or liable for any advice given to third parties, or any investment decisions or trading or any other actions taken by you or by third parties based on information contained in this document.