



## The Active Risk Puzzle

Almost all institutional investors strive to use some active management to increase returns. However, when you look at how much active risk they actually take, it is almost invariably a tiny fraction of the fund's total risk. And, this pattern of low active risk-taking is remarkably consistent across investors – a puzzling observation.

You might be asking yourself, why is this behavior so surprising? If alpha is a valuable, but scarce resource, then shouldn't everyone be searching for it and finding it in small amounts? What is so puzzling?

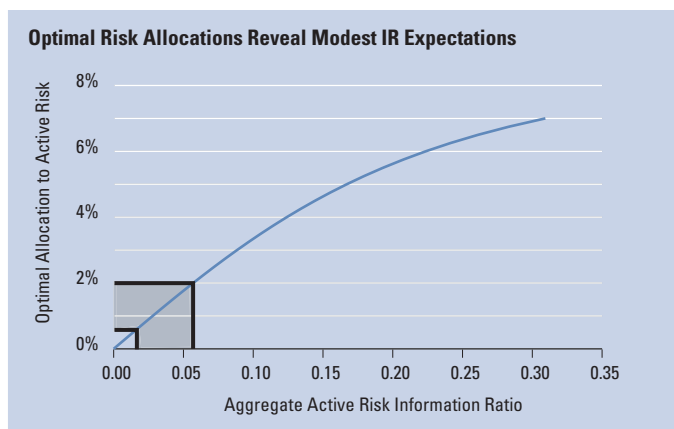
### Not Everyone Should Be Searching For Alpha

Just as managers have different degrees of skill in producing alpha, funds have different degrees of skill in picking managers. Alpha only accrues to managers with above-average skill, and, quite simply, not all funds are going to be able to find above-average managers. Funds that have average, or below-average, ability to find skilled managers would be better off investing passively and minimizing fees. Logically, one would think that at least half of funds would be in this category. However, virtually all plan sponsors take some active risk, reflecting the belief that almost all funds think that they can add value.

On the other hand, those funds that do have skill at picking managers ought to be able to create excess return from uncorrelated sources of risk. This ability should be hugely beneficial to their risk/return profile, and make it highly attractive for them to pursue active risk. These funds should take much more than a tiny bit of active risk, creating only a tiny bit of value. Instead, they should take as much active risk as they can in order to take advantage of significantly higher returns at lower levels of portfolio risk.

### Taking the Right Level of Active Risk?

As shown in the figure,<sup>1</sup> the allocations to active risk of typical pension funds range between 50 and 200 basis points. These allocations are optimal if the aggregate information ratio of the active risk is only between .01 and .06. It is hard to understand why all funds should have such incredibly modest expectations. Indeed, most would agree that some skilled active managers should deliver IRs of .3 or better! Yet they don't invest in ways consistent with this belief.



### Why is Their Real World Behavior Different?

Many funds may be unsure of their ability to pick managers with above-average skill, and that uncertainty may be part of the explanation for the puzzling behavior. However, there are many other potential explanations as well, such as a high aversion toward active risk or fund managers worrying about career risk rather than fund risk. There is a tendency to invest “along with the pack” because it is “safer.” Governance restrictions, such as Board decisions or Investment Guidelines, may introduce costly constraints on sensible active risk taking. And yet another potential explanation is that active risk and strategic asset allocation decisions have historically been linked, since fund managers could not easily separate the allocation of risk along these two dimensions. Most likely, it's a combination of many of these factors.

Whatever the explanation for this behavior, we think it is unlikely to persist. It is simply not optimal for all funds to take just a little bit of active risk. We are already seeing clear signs of change in the industry in terms of active risk seeking. Some institutional funds are starting to follow the lead of many endowments and foundations by structuring their portfolios to include more alternative assets, hedge funds, overlays and other sources of active risk. In fact, median strategic allocations to

<sup>1</sup> Source: Goldman Sachs Asset Management. The figure assumes a portfolio volatility of 9%, with risk coming from a combination of market risk, with a volatility of 16%, and an equity risk premium of 4%, and uncorrelated active risk with the information ratio given on the horizontal axis.

hedge funds among North American institutions have been steadily increasing, from 2.5% in 2001 to 5% in 2003, with a 7% allocation forecasted by 2005. European institutions reported a similar jump from 1.7% in 2001 to 3.6% in 2003, with a 4.5% allocation forecasted for 2005.<sup>2</sup> New tools of risk management and recent evolutions in the asset management industry, such as increased availability of absolute return and portable alpha products, are allowing funds that wish to take more (or less) active risk to do so.

### The Future of Asset Management

Given these evolutions, we expect to see changes in active management services:

**Growth of hedge funds.** The hedge fund industry, which provides active management in concentrated forms, has grown exponentially in the past decade. In fact, hedge fund industry assets grew from approximately \$167 billion in 1993 to \$818 billion in 2003.<sup>3</sup> This growth should continue for some time. Moreover, the growing demand for hedge funds will result in both an increase in the number and type of hedge funds in the marketplace. Since compensation structures for skilled individuals in this industry are among the best available, we believe there will be a continued migration of skilled portfolio managers to hedge funds.

**Growth of overlay strategies.** Similarly, we have seen exponential growth in the demand for overlay strategies, such as active currency and commodity management, as well as global tactical asset allocation (GTAA). Today, the top 10 TAA managers manage over \$53 billion.<sup>4</sup> Among many attractive features, these sources of active management feature minimal ratios of capital to active risk, and therefore, can provide more alpha per unit of capital. Also, certain overlay strategies are less capacity-constrained, especially if they invest in larger global markets such as currency.


**Searching for alpha in less efficient markets.** As funds seek to increase their alpha, they are focusing on less efficient parts of the capital market. Active management of private equity, real estate, emerging markets, high yield bonds, distressed debt, and so on, may be perceived as more fruitful sources of alpha than

the traditional fixed income and equity markets. Portable alpha strategies, which decouple the underlying market exposure from the active management activities, should also become more popular and widespread.

**Relaxing constraints.** We believe funds will loosen the constraints on active managers that impair their ability to create alpha. In particular, the traditional stock picking equity manager who has a no-short constraint may be disadvantaged relative to low-risk enhanced index strategies on the one hand, and high-risk long/short hedge funds on the other, both of which create alpha from identifying stocks that are expected to have relatively poor performance.

**Survival of the fittest.** Finally, we expect the markets to continue to become more efficient and the sources of alpha to evolve over time. As capital flows into hedge funds and other sources of active management, the ability of skilled managers to produce superior performance should decrease because of the relatively constant supply of alpha and the increasing transaction costs associated with larger assets under management. Thus, finding the best sources of alpha will require a dynamic, contrarian search process that focuses on areas that are currently out of favor.

As markets get more efficient, finding skill will become more difficult. And, since finding manager skill requires skill at the fund level and is a zero-sum game, Boards and CIOs will have to heighten their focus on developing sustainable skill advantage over their peers, or default to an indexing strategy at the lowest possible cost. Smart funds will either maintain a pure indexed approach at the lowest possible cost in staff and fees, or invest in active risk, develop the organizational skills and resources to pick skilled managers, and jealously protect this skill. The days of "investing with the pack" are numbered.



For more information on this topic or for a copy of our Perspectives paper, visit our website at [activealpha.gs.com](http://activealpha.gs.com).

<sup>2</sup> Source: 2003 Goldman Sachs Russell Report on Alternative Investing. 166 North American and 71 European institutions were surveyed.

<sup>3</sup> Source: Hedge Fund Research, Inc., Fourth Quarter 2003. Report dated February 2004.

<sup>4</sup> Source: Global Investor Magazine, TAA Comes Back from the Dead, November 2003.

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