Some Thoughts on the Evolution of the Design of Financial Products

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"It's not about what it is, it's about what it can become."

Dr. Seuss, The Lorax

It is the perennial challenge of investors to balance the relationship between risk and reward. No sensible person enters the capital markets without the hope of reward and some trepidation about the uncertain road to profit. [1] Indeed, no one with a modicum of knowledge about markets seeks a return on capital without some regard for the sentinels of risk that stand guard against easy capital gains. Risk does not mean danger. [2] Instead, it bespeaks caution in the face of the uncertainty of what the future might hold for an investment. And, the relationship between risk and return varies by investor – depending upon investment objective, time horizon, and resolve in the face of volatility. Yet, all investors are united by a desire to capture the rewards of the market – and then some, if possible – without recording a real loss of capital.

There has long been an expectation that growth is an immutable feature of the market. It was assumed to be a function of growth in the overall economy. In that way, America became a nation of equity risk takers, willing to take stock in the nation. [3] With a long enough view, one could be relatively confident that savings could be deployed in the market to achieve a higher rate of return than bonds. Equity investing has long been seen as a means to secure some measure of affluence or even to create wealth. Lately, the strength of that assumption has been compromised in the minds of many investors for a variety of reasons. The causes for a growing wariness of the market are varied and subject to dispute, but we might consider the following as contributing to the skepticism of market participants: unprecedented and sustained central bank intervention in the marketplace; episodes of excess volatility; the breakdown of market structure; the apparently privileged participation of some actors (see high speed traders, dark pools etc.); and the widespread experience of real and substantial losses by all investors. Moreover, our aging population is necessarily more risk averse. [4] The mindset of investors is increasingly attuned to the risks in the market and the importance of managing them. Unsurprisingly, the tools to do so are increasingly in demand.

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Investors are similarly concerned about the efficacy of active management. Despite the commercial success of active managers, it has long been demonstrated in academic research that such managers rarely outperform their benchmarks over any meaningful interval of time. [5] The evidence for the thesis is abundant and obvious. [6] The market, however you may define it, is truly the master of the manager. [7] At the same time, active management also generally comes at a

[1] *See, e.g.* William F. Sharpe, *Portfolio Analysis, 2* J. FIN & QUANTITATIVE ANALYSIS 76, 81 (Jun. 1967) ("One of the major characteristics that distinguishes finance. . . from traditional economics is its insistence that risk permeates the business world and must be dealt with explicitly.").

[2] *See Peter Bernstein on Risk,* McKinsey & Company (Jan. 2008) available at http://www.mckinsey.com/business-functions/risk/our-insights/peter-l-bernstein-on-risk.

[3] *See, e.g. Shareholder Letter of Berkshire Hathaway, Inc.* (Feb. 28, 2016) at 7-8 ("For 240 years it's been a terrible mistake to bet against America, and now is not the time to start. America's golden goose of commerce and innovation will continue to lay more and larger eggs.").

[4] R.A. Morin and A.F. Suarez, *Risk Aversion Revisited*, 38 J. FINANCE 1201 (1983). *Cf.* Hui Wang and Sherman Hanna, *Does Risk Tolerance Decrease with Age?,* 8 FIN. COUNSELING AND PLANNING 27 (1997).

[5] Burton Malkiel, *Reflections on the Efficient Market Hypothesis: 30 Years Later*, 40 FINANCIAL REVIEW 1-3 (2005) (suggesting that "a blindfolded chimpanzee throwing darts ar the stock pages could select a portfolio that would do as well as the experts" and observing that large cap equity funds are outperformed by the S&P500 Index for a 1, 3, 5 and 10 year period, between 63 and 90% of the time).

[6] *See, e.g.* Aye M. Soe*, SPIVA U.S. Scorecard, S&P Dow Jones Indices Research (2015)* (observing that, during 2015, "66.11% of large cap managers, 56.81% of mid-cap managers, and 72.2% of small-cap managers underperformed the S&P500®, the S&P MidCap 400®, and the S&P SmallCap 600® respectively.").

[7] *See,* e.g. Juliana Hadas and Andrea Pompili, *Can Active Management Make a Comeback?,* Neuberger Berman (Mar. 2015) (observing that "active managers have had difficulty in outperforming their benchmarks during the six-year equity bull market since the global financial crisis").

higher price. This combination of relative underperformance and higher fees has led to a demand for different and more cost effective approaches to asset management. Economy, efficiency and exposure in the form of betas, both traditional and alternative, are the watchwords of the time. Investors, like all consumers today, are seeking a greater measure of value for their money. And, in this age of Uber, with information and digital innovation abounding, incumbent money managers are being pushed back on their heels. [8]

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The historical supremacy of the active manager cannot be argued. However, that historical dominance is giving way to new processes and strategies that are defined by certain factors and implemented by systematic rules, as opposed to individual discretion and subjective judgment. [9] Indeed, something similar is happening in the financial advisory business (witness the rise of the robo-advisor, but that is the story for another day). [10] A simple example from popular finance may illustrate the sea change in investor beliefs and behavior. Let's look at the rise of Vanguard which is the leading sponsor of "pure beta" investing with a broad menu of low cost mutual funds and ETFs which are designed around capitalization weighted indices. The company was started in 1976 by Jack Bogle who, in his senior thesis at Princeton twenty five years earlier, had observed that around three-quarters of mutual funds did not earn any more money than if they invested in the largest 500 companies simultaneously, using the S&P 500® Index as a benchmark. In other words, three out of four managers could not pick better specific "winners" than someone passively holding a basket of the 500 largest public U.S companies. The industry resistance to this observation was and remains powerful. Vanguard's first offering raised a paltry $11 million and was a disappointment to the underwriters. Today, the company manages over $3 trillion of mutual funds and ETFs and is growing apace with investor preference for efficient market exposure, instead of uncertain manger skill offered at a premium. By our observation, the fund flows into Vanguard alone have been so substantial as to extract approximately $16 billion of fees from the asset management industry in the calendar year 2015. [11] The relative allocations overall between passive and active funds were no less remarkable: passive index mutual funds and ETFs brought in $365 billion of new money while actively managed funds saw $147 billion walk out the door. [12] Investment strategies with strict definition, rules of operation and transparency, not to mention liquidity, are a growing preference among investors. The corresponding decrease in the fee burden that comes with these products and strategies is seen as another advantage in the effort to preserve and enhance capital and is made all the more important, on an absolute basis, by a persistent low interest rate environment.

Much of the academic and popular discussion to date regarding the relative merits of active and passive management has focused on long-only investment models. [13] Discretionary management, in the catechism of the efficient market hypothesis, was a fool's errand - and an expensive one at that. [14] In the meantime, an industrial scale enterprise emerged in the way of alternative investments which, in large measure, have been actively managed (for the purposes of this

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[8] *See, e.g.* Marlon Weems*, Disintermediation: The Real Race to Zero, TABB FORUM* (Sep. 25, 2013) available at http://tabbforum.com/opinions/disintermediation-the-real-race-to-zero (arguing that institutional accounts, for example, "have awakened to the logic of 'insourcing'.").

[9] *See*, e.g. *Understanding Smart Beta,* TOWERS WATSON (July 2013) (defining smart beta as "simply about trying to identify good investment ideas that can be structured better, whether that is improving existing beta opportunities or creating exposures or themes that are implementable in a low cost, systematic way.").

[10] *See, e.g.* Michael P. Regan*, Robo Advisers to Run $2 Trillion by 2020 if This Model is Right,* BLOOMBERG BUSINESS WEEK *(Jun. 18, 2015).*

[11] Eric Balchunas, *Passive Revolution*, BLOOMBERG BUSINESSWEEK (Dec. 14-20, 2015).

[12] *Id.*

[13] *See*, e.g. Malkiel, *supra* note 5. In fairness, in large measure, the difference results from the fact that mutual funds are required to make their data public while private funds are not.

[14] *See* Burton Malkiel, *A Random Walk Down Wall Street*, 1st Edition, New York, W.W. Norton, 1973. *Cf.* Sanford J. Grossman and Joseph E. Stiglitz, *On the Impossibility of Informationally Efficient Markets*, AMERICAN ECONOMIC REVIEW 70 (June, 1980) (positing that a completely passive and efficient market will dry up active management but then create profit opportunities which, in turn, will lure back active managers who, once again, will become successful).

analysis, we will consider only those alternatives that focus on liquid markets, as opposed to venture capital, private equity, real estate and other private market pursuits). In the last twenty years, for example, the hedge fund industry has gone from approximately $200 billion in assets under management to approximately $3 trillion. [15]

Hedge funds may be considered the ultimate expression of active management, since they maximize the utility of the information and observations they glean from the market by taking long and short positions. And their success in generating attractive rates of return in both nominal and risk adjusted measures has challenged directly the theory of efficient markets. Their headline value was often a function of a sensational trade, a particular year of extraordinary returns, or the cult of the manager. Think here of the celebrity that accrued to George Soros as the man who "broke" the Bank of England and forced the United Kingdom to withdraw from the European Exchange Rate Mechanism, the precursor to the Euro. The real value of hedge funds, however, has been their strategic differentiation. They invest long and short, thereby maximizing the potential of information and observations a manager may take from the markets. Regardless of the relative ability of a hedge fund manager to select securities, the long/short nature of the hedge fund vehicle provides an advantage. Its generic portfolio construct offers an inherent potential to mitigate volatility. The fact that some meaningful, if variable, portion of the portfolio is short tends to provide some protection in declining markets. Consistency, lower volatility and the avoidance or reduction of loss have been, in the main, the promise of hedge funds and the reason for their growth. [16]

Whatever their merits, there has been a steady and substantial decline, by any measure, in hedge fund performance in recent years. [17] And many now believe that whatever inefficiencies animated their extraordinary expansion have largely been ironed out. [18] At the very least, the amount of capital being deployed and the number of practitioners has grown beyond the opportunity set. One could also argue quite convincingly that fee structure of the industry is also part of the problem. The by now proverbial 2 and 20 fee structure consumes too much of the return potential of the vast majority of managers. That is not to say that there is no value in these strategic alternatives, but that change is coming and it will be informed by economy and efficiency. As a recent Economist article surmised: "a recent wave of fund closures, and the expectation that more will follow, suggest the industry's era of stratospheric growth may well be in the past." [19]

The original delivery system for hedge funds was a privately offered limited partnership which generally provided an investor with extremely limited liquidity; one year lock-ups, quarterly liquidity with 45 days' notice was not unusual. As hedge funds gained ever broader success among private banking clients and institutional investors, the industry moved to expand into the retail channel. Thus, did 'liquid alternatives" come into being. The main vessel for the delivery of alternative strategies has been the open-ended mutual fund. From a base of less than $40 billion at the time of the financial crisis, alternative investment mutual funds have grown to nearly $300 billion, representing a compound annual growth rate of more than 40% during the period. [20] Some speculate that demand for these structures will push the assets in these funds past $1 trillion by 2018. [21]

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[15] *See Opportunities and Challenges for Hedge Funds in the Coming Area of Optimization,* CITI INVESTORS SERVICES (2014) (forecasting that core hedge fund industry AUM will rise to $4.81 trillion by 2013).

[16] *See*, e.g. Krista Matthews, *Is the Hedge Fund Heyday Behind Us?*, CAMBRIDGE ASSOCIATES PERSPECTIVES (2015) ("hedge fund exposure has reduced the variability of portfolio returns in a meaningful way, providing superior risk-adjusted returns").

[17] *See Hedge funds: Not dead, just resting*, THE ECONOMIST (Feb. 20, 2016) available at http://www.economist.com/news/finance-and-economics/21693260-bunch-hedge-funds-have-closed-has-industry-reached-its-peak-not-dead.

[18] *Id.* ("The field has become crowded and a natural selection of the fittest might be just what it needs.").

[19] *Id*.

[20] *See The Rise of Liquid Alternatives: Presentation to CAIA in Chicago*, CITI INVESTOR SERVICES (May 21, 2014) at 4.

[21] *Id*. at 26.

Efficiency in content and structure must then be the contemporary investment imperative.

It is notable that the growth of these funds accelerated in the years following the financial crisis. In part, their appeal can be understood as a function of the relative performance of the several particular alternative strategies to the outsized losses in the equity markets. To a certain extent, the financial crisis catalyzed this new line of business and validated its defensive *bona fide*s as part of an overall portfolio. In the minds of many investors, the burden of return was expected to come from other investment and different aspects of their portfolios. And so, given the robust and sustained performance of the equity markets since 2008, there have been performance disappointments which, in hindsight, seemed almost inevitable. Some of that disappointment also derives from the high cost of the delivery vehicle. Mutual funds are an expensive "wrapper" for a relatively expensive strategy. Even allowing for the general prohibition on most forms of incentive fees in a mutual funds, the combination of manager fees and funds fees inevitably compromise returns, especially if we are entering a period of lower global growth and correspondingly lower market returns. Efficiency in content and structure must then be the contemporary investment imperative.

The burgeoning opportunity in the marketplace is manifestly not more of the same. Instead, it begins with developing an alignment between investors and product sponsors rooted in honest observations about active management. Active management has limited, marginal utility in the public markets, especially if it continues to be offered to investors at a premium price point. For many investors, better value might be realized in an allocation among variously defined sources of beta, including traditional and alternative. One might call these allocations "structured beta" in the sense that they offer participation in the market within certain parameters. That is to say the outcomes over a certain interval of time may be constrained - or structured - to correspond to the risk tolerance of an investor, be they an individual or an institution. These structured exposures should be characterized by a measure of lower cost, and a high degree of transparency and liquidity. High fees over any meaningful interval of time only compromise returns which are generally mean reverting. Of all the professionally managed assets in the United States today, nearly half come from individual investors (47%). [22] Of that cohort, almost three quarters (73%) have less than $5 million in managed assets. [23] The lines between traditional and alternative have grown less clear or meaningful in recent years. Managing the exposure to the market or an aspect thereof, managing risk and securing a reasonable return have become the topical priorities for the majority of investors. Those product sponsors who can articulate a value proposition that addresses the palpable concerns of investors will take a meaningful share of the assets already deployed in the market and those to be allocated in the future.

The evolution of liquid alternatives is part of a larger phenomenon. It is but a piece of the well established migration of investment capital from active to passive management in traditional asset classes. It will surely differ in the particulars, but the objective will be very much the same. The market and its various components have certain return characteristics. Financial technology is such that access to these exposures may be obtained efficiently, in a liquid format, and without incurring high costs or ancillary credit risks.

Indeed, product developments that complement or improve upon the mutual fund are coming into view.

[22] *Id.* at 9.

[23] *Id.*

ABOUT OLDEN LANE

Olden Lane is an innovative financial services firm that works closely with institutions to structure alternative streams of return within fund wrappers. Established in 2015, Olden Lane is grounded in a culture of high performance, operational excellence, and a spirit of partnership with our clients.

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