Rethinking Investment Management Strategies
By Gary Case

In a recent article for the Investment News, Tim Knepp, Chief Investment Officer for Genworth Financial Asset Management, Inc., asserts that perhaps it is time for those who manage investment portfolios to ask whether traditional ways of thinking about investment management have gone awry. Traditional methods of meeting the dual (and often competing) objectives of asset growth and capital preservation have involved careful diversification across asset classes to balance risk and return through multiple market cycles.

With recent market volatility pummeling traditional portfolios, three observations point to a new, more flexible approach to asset management:

1. The long-term benefits of diversification don't include a shield against periods of significant stress. Recent history illustrates how even a supposedly diversified portfolio becomes highly correlated during market meltdowns, negating the risk management goal that diversification seeks to achieve.
2. Some risks can't be modeled. Traditional asset class distinctions and fundamentals were overwhelmed by the gale-force winds of liquidity needs as regulatory forces, systematic unwinding of debt and the impact of flexible hedge fund positions on markets have skewed the investment landscape.
3. The lines separating equities, debt instruments, futures, options, and other derivatives have blurred. The economics fueling market turmoil affected returns regardless of whether debt or equity instruments were held in a portfolio, blotting out traditional diversification benefits. In fact, many stocks are valued so low as to mimic call options on future cash flows, while corporate bond valuations have taken on the upside profile of equities.

A new approach is needed to meet the current challenge of portfolio management. This approach must look for investment opportunity not through the lens of traditional asset allocation, but without regard to indexes, categories and conventional descriptions. By evaluating the factors that drive various investment options, and having the flexibility to implement management strategies without regard to conventional asset class descriptions, portfolio managers are free to find the strongest risk/reward trade-off rather than meeting a rigid asset allocation requirement. Ultimately, portfolio positions could be established using the concept of absolute return, tying diversification and asset allocation to fundamental and structural challenges rather than historical averages and traditional definitions.

This increased flexibility could have the effect of making portfolio objectives easier to manage. The challenge of such an approach is to combine quantitative and qualitative measures in evaluating opportunity and skillfully evaluating and managing risk at the portfolio level.

While the vast majority of portfolios will likely continue to be managed using traditional methodology, ponder the wisdom of having at least a portion of your portfolio managed to first protect principal with the secondary goal of producing a real (absolute) return regardless of broad market movements. Managers using this new method are hard to find, but worth the search.

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