

# Optimising opportunities

Matthias Dworzack, Hamburg talks to **efm** about index optimising fund of funds, based on Markowitz' Portfolio Selection

**T**ogether with Sal. Oppenheim KAG you have set up Advisor Global OP, an index-oriented fund of funds. Beforehand, you have done some research about index investing. What have been your most interesting findings which have proved your idea that an index oriented fund of funds is needed on the German market?

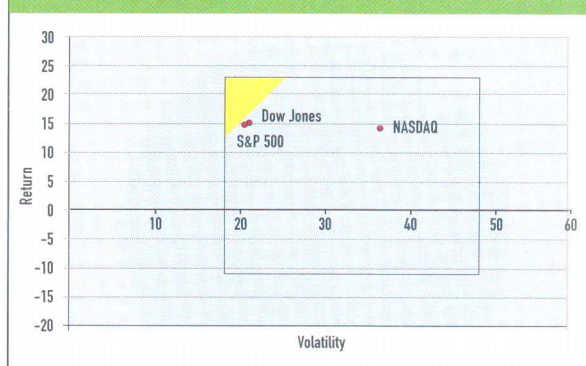
It is said that long-term indices outperform up to nine out of 10 actively managed funds. We focus on the relation of risk and return when making our investment decisions. Usually, people only look at the return of an investment. But I think it is more professional to consider as well the volatility a return is generated with. We have therefore analysed various markets to find out with what risks returns are realised.

Let us take the North American fund market from 1997-2001 as an example: all funds – irrespective of their main investment focus – investing in North American equity were analysed. The least successful funds realised returns of -12.1 per cent pa as opposed to the most successful ones that performed 22.9 per cent pa. All other funds generated a percentage in between (over a five year period). However, the risk for each fund varies notably. The highest average returns were realised with volatilities between 19.2 per cent and 49.8 per cent. The risk and return-performances of all North American funds can be found within the table.

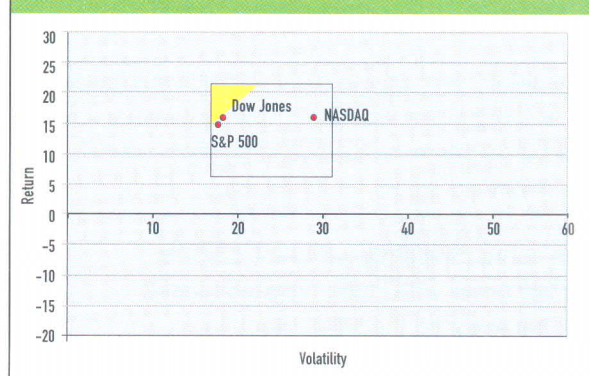
We are now looking at the Dow Jones Industrial, S&P 500 and the Nasdaq. It is apparent that the average annual return of the technology and blue chip indices are similar. This is rather interesting for the long-term investor. The Nasdaq investment bore a much higher risk: the volatility of 37.4 per cent pa was almost twice as high as that of the Dow Jones (21.7 per cent) and S&P 500 (21.1 per cent).

Just a few funds showed a more positive relation between risk and return; they are positioned within the yellow triangle. Only these funds have gained a higher return for the acceptable risk of the investment: they are more efficient.

**FIGURE 1: US STOCKMARKET 1997-2001**



**FIGURE 2: US STOCKMARKET 1992-2001**

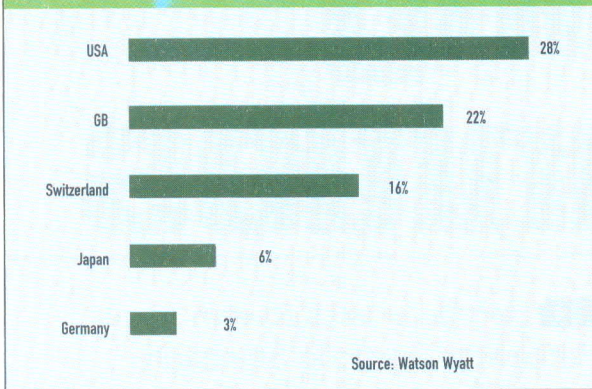


We found that the results for a 10 year period are similar: the proportions are different, but the relation between the US-market and the large indices stay equal. Also, we have conducted the same analysis for the other major financial markets. The results were similar to those for the US-market.

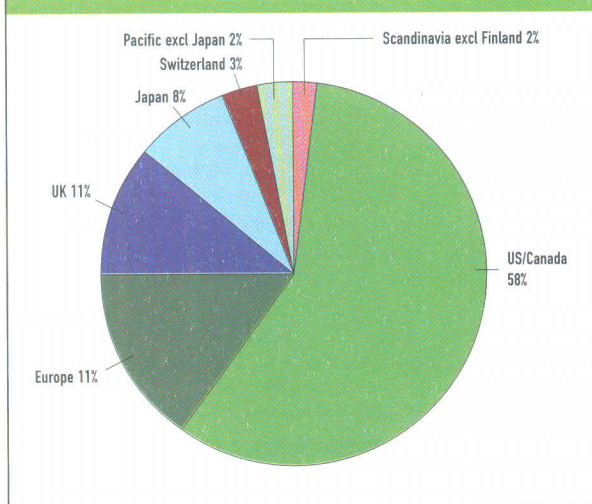
The percentage of index-oriented products in Germany in 2001 was only 3 per cent, which shows that the German private investors have not (yet) discovered the advantages of index-oriented funds.

There are a number of indices that can be covered by index funds in Germany. However, until March 2002 it was not possible to buy a fund or funds of funds for the MSCI World Index. Yet, this portfolio is a very good

**FIGURE 3: MARKET SHARES OF INDEX FUNDS WORLDWIDE**



**FIGURE 4: THE MSCI WORLD INDEX**



base investment. Due to the worldwide diversification it is an investment with a very low systematic risk. We decided therefore to launch a fund which is MSCI World Index oriented.

**How do you select the different markets you will cover with index-oriented funds?**

First we analysed the MSCI World Index and noticed that the index consists of up to 20 country allocations, with some making up only 0.2 per cent or 0.3 per cent. The index-maker is surely of the same opinion as they aggregated the MSCI country portfolios to regional groups as shown in the pie chart.

It was clear to us that we wanted to set up a fund of funds concept, based on the seven geographical MSCI World Index segments.

**And how do you then select the individual funds? What will you do when no index fund is available for a specific market?**

There are index oriented funds for some financial markets. Various companies have launched funds that mirror markets such as DAX, Euro Stoxx 50, S&P 500, Nikkei 250 and others. The problem with the congruence

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of the underlying index is handled differently; the success of the solutions varies. Exchange traded funds are a rather new market segment in Germany. They also quite successfully mirror important indices.

Generally, for the fund of funds concept, only a maximum of 20 per cent of the total fund volume can be invested in each target fund. But more than 50 per cent of the MSCI World Index is invested in the US and the Canadian market. Hence, at least three funds have to cover the US and Canadian markets.

Furthermore, there is no MSCI USA fund. Morgan Stanley's business principle is obviously the reason for this. The company publishes only performance data but no further information on the portfolio structure of the different MSCI indices. Finally, there are no index oriented fund products for certain regions, such as Scandinavia.

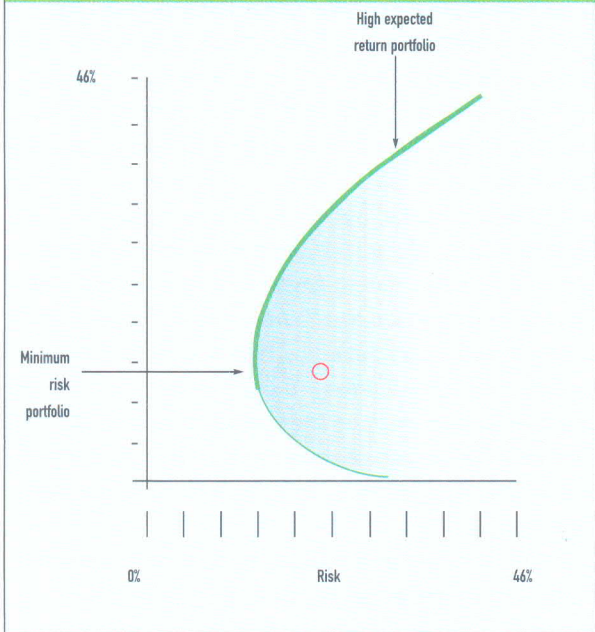
Should there be no index funds to mirror the MSCI market, we will select substitute investments as follows:

- we will pick funds that show the most congruent performance to the index;
- they have to be strongly correlated with the underlying index, almost perfectly positive;
- their beta must be similar to the index, most suitable is a beta of one; and
- finally, the fundamental aspects have to be index-like: Their investment universe must be the index Blue Chips. All in all, they have to be as similar to the benchmark as possible, to be chosen as an index substitute. Based on this we create a matrix with the possible target funds.

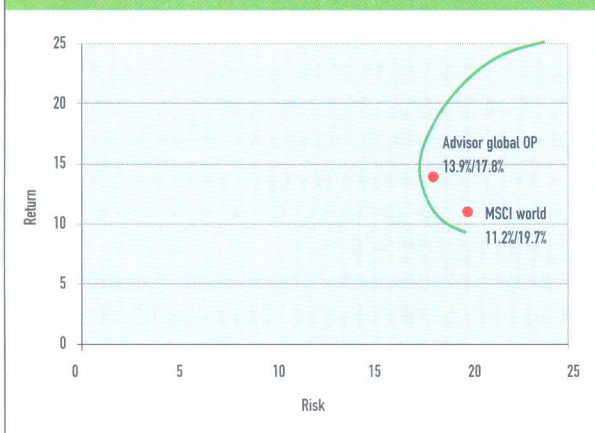
**FIGURE 5: CUSTODIAN AND MANAGEMENT CHARGES**



**FIGURE 6: MSCI WORLD INDEX PORTFOLIO**



**FIGURE 7: PORTFOLIO ADVISOR GLOBAL**



**As you are investing in several different index funds, what is your benchmark? Do you believe you will be able to reach it, even though as a fund advisor you will hold a liquidity position and your fund is bearing costs?**

As you know, the MSCI World Index portfolio is a compilation of different national or regional indices. Therefore, for regional and national investments the relevant MSCI Index is the benchmark. The MSCI World Index is the benchmark for Advisor Global OP as such and we hope to be able to outperform it.

One of the reasons why we think this is possible is that – together with our partner Sal. Oppenheim KAG – we have developed a low cost structure: the annual management fee is 0.9 per cent and our maximum transaction charges are 0.125 per cent. Also we buy selected funds at net asset value. If you consider the charges of our fund you will notice that Advisor Global OP is one of the very low-cost fund of funds on the market.

Also, we do not perform liquidity management; we

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always – as much as possible – invest the fund capital. And in our asset management, we focus on our main expertise: to scientifically mirror and optimise a world-wide portfolio.

In Figure 6 we have plotted a number of expected returns and risks that you could achieve by a continuous variation of the MSCI World Index portfolio. Each point shows the expected return and standard deviation from investing in a MSCI World Index portfolio, which is a little different from the original. The country allocation varies each time for one or several percentage points. It can be seen that the MSCI World Index portfolio's position is inside the broken-egg-shaped area.

Since we wish to reduce risk or to increase expected return we will be interested in those feasible portfolios that lie along the heavy green line. Those combinations of assets are called efficient portfolios – you will either not realise a higher outcome from your accepted risk or you cannot realise the expected return with a lower standard deviation.

As you can see, the MSCI World Index is not an efficient portfolio in the sense of Markowitz' portfolio selection. For Advisor Global OP we decided to choose a varied MSCI portfolio between the minimum-risk portfolio and the maximum-expected-return portfolio. We do so precisely because we like high expected returns and dislike high standard deviations. As a result we will invest in a portfolio you see in Figure 7.

We expect a higher return than the MSCI World Index performance, and on the basis of past experience the standard deviation of Advisor Global OP's portfolio is lower than the risk of the MSCI World Index.

And it seems as if we are doing a good job: the first statements of the German Association of Performance Measurement are positive. In its young history, Advisor Global OP's performance is 2.5 per cent higher than the benchmark. ●

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