

The Season of Reckoning

2001 was a difficult year for fund managers. Their performance should be assessed in relative terms, and not just by low rates of return.

In the next few weeks, most fund managers will be presenting their investment results for the year 2001. I expect that, when doing so, the majority of them will sound rather modest, perhaps even a little apologetic, about their investment performance. Indeed, the year has been a particularly difficult one for investment managers. Financial markets were volatile in 2001, with large downward adjustments, and there was no lack of shocks. But I do not think they need to be too sorry, just because the actual rates of return they achieved are low in absolute terms or even negative. What is important – and there is a need for customers who entrust their funds with fund managers to realise this – is whether or not the investment managers were able to beat the benchmark returns of the investment portfolios concerned.

The benchmark return is the investment return of an imaginary portfolio made up of a benchmark allocation of financial assets that reflects the customer's preference, after balancing the three crucial factors in investment management – risk, liquidity and return. Whether one is talking about a specially designed portfolio to suit the special needs of a particular customer,

or a unit trust type of portfolio that has multiple investor participation, most investment managers work with such a benchmark allocation of financial assets. One way of working with the benchmark allocation is to follow it exactly, by design or by default, in which case there should not be significant difficulty in achieving the benchmark return. And not a lot of investment skill is involved in such a passive investment management style. Doing nothing is not very demanding. The other approach is for the investment managers to take judicious, tactical deviations from the benchmark allocation in order to beat the benchmark return. This requires skill in predicting macroeconomic trends, including, crucially, those concerning exchange rates and interests rates. For example, in 2001, with the benefit of hindsight, those investment managers that were underweight (below the benchmark) in equity and overweight in bonds should stand a good chance of beating the benchmark return. Investment managers can also try and beat the benchmark return by picking “winners” within each asset class without deviating from the benchmark allocation, and this requires rather more in-depth knowledge at the microeconomic level about, for example, the outlook of technology stocks.

Thus, for an investment portfolio that is supposed to be actively managed, we should look at the actual investment return relative to the benchmark return in assessing the performance of the investment manager. This is the way we look at the performance of the many external investment managers that we employ to assist us in the management of the Exchange Fund. This is also the way we

look at our own investment performance with the larger part of the Exchange Fund that is managed in-house. Investors, in entrusting their savings to investment managers, should also consider monitoring the performance of their fund managers in this manner. They should at least realise what their benchmark allocation is like and be informed by their investment managers about the benchmark rate of return as well as the actual rate of return. They should also look at the performance, both actual and relative, of the fund in question over a longer term than just one year: this is particularly relevant for a fund such as the Exchange Fund, one of the investment objectives of which is to preserve the long-term purchasing power of the assets.

In 2001, equity investments did badly in all major markets across the world. Losses well into double digits were recorded. The Hong Kong stock market, for example, was down by nearly 25%. Bonds nevertheless did well, thanks to the successive cuts in US interest rates, but this applies only to the US dollar (and selected US dollar-linked, robust) bond markets. Bond markets in other currencies did not do so well, particularly when returns are measured in US dollar terms, as we in effect do in Hong Kong. Indeed, global government bond indexes of one-to-five-year maturity showed only a meagre increase of about 0.3% in 2001. For bonds of one-to-ten-year maturity, these indexes showed a decrease of about 0.75%. This was significantly the result of the weakness of major currencies against the US dollar. The yen depreciated in 2001 by 13.1% and the euro by 5.6%. Thus, we can expect substantial falls in

the value, for example, of equity portfolios, and perhaps for such falls to be partly offset by gains in the bond market, depending on the extent of bond investments allowed for in the benchmarks. Multiple-currency portfolios will also not do well in absolute terms, when measured in US dollars.

It has been a difficult year for investment managers. We await with interest the report cards of the fund management industry in Hong Kong, and with some trepidation the numbers on the Exchange Fund that we are now crunching out.

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