



# Russell Communiqué

Our perspective on current and emerging investment issues

## Risk parity strategies: A smarter way to allocate risk?

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## EXECUTIVE VIEW

# Trending topics

By: Bob Collie, FIA, Chief Research Strategist, Americas Institutional

The investment debate is constantly moving on—fresh ideas (and recycled old ones) bubble up in the conversation and take their turn on center stage for a while until another topic takes its turn.

In this issue of *Russell Communiqué*, we touch on four of today's trending topics. Leola Ross and Steve Murray kick us off with some thoughts on risk parity, a category of investment product that has attracted its share of attention recently. Heather Myers and Lila Han highlight the shift among many investors toward a more dynamic response to changes in the market environment, and address the implications of that for the decision-making process.

Our Q&A column tackles another current trend: the trend toward outsourcing, or OCIO. Michael Thomas describes Russell's experience and views on the implications for investors of an outsourced approach: the changes in responsibilities and duties of fiduciaries. And in our *Opinion* column, Dick Davies lays down a challenge to the sponsors of defined contribution plans: should you really be aiming for "good enough," or should you aim to be as good as the best?

We don't know what the next set of trending topics will be, but whatever turn the investment debate takes next, we aim to stay a part of it.

Thank you for reading,



Bob Collie, FIA  
Chief Research Strategist, Americas Institutional



Bob Collie

## INVESTMENT FOCUS

# Risk parity: A smarter way to allocate risk?

By: Leola Ross, Ph.D., CFA, Director, Capital Markets Research, and Steve Murray, Ph.D., CFA, Director, Asset Allocation Strategies



Leola Ross



Steve Murray

## WHAT IS RISK PARITY?

We use the term “risk parity” to describe a collection of strategies focused on equalizing or carefully targeting the risk contribution of each asset class in a portfolio. We will use the phrase “equalizing risk contribution(s)” for either circumstance.

- › By equalizing risk contributions, a risk parity manager seeks to enhance the diversification of a portfolio. Risk parity managers typically use leverage to achieve a better risk/return ratio than to those of more traditional portfolios, the archetypal example of which is the classic portfolio with 60% equity/40% bonds.<sup>1</sup>

Due to their use of leverage and the need for regular rebalancing, managers implementing risk parity often use futures, swaps and ETFs instead of trading physical shares.<sup>2</sup> In risk parity products, allocations to risk assets, factors and/or economic scenarios vary with volatility forecasts, and they require regular adjustment.

Assumptions underlying the risk parity story typically include the following:<sup>3</sup>

- › Risk (i.e., covariance) forecasts are more reliable than return forecasts.
- › Sharpe ratios are either roughly equal or not robust enough to be forecasted with high confidence.
- › Risk has a direct relationship to return over the long term.
- › Leverage, especially implicit leverage of futures, does not materially increase the liquidity risk of a portfolio.
- › By using leverage to construct a portfolio with lower overall risk, a risk parity manager intends to achieve a higher return per unit of risk than characterizes a 60/40 portfolio.
- › Broad asset classes have low correlations to each other. The lower the correlations, the greater the benefits of risk parity.

Leverage in risk parity is generally based on the use of futures and hence largely (or, in some cases, completely) implicit. The major difference between risk parity and funds that have experienced problems with leverage in the past is the use of highly liquid instruments. While we cannot know what the future will hold, leverage has not, in the past, caused the same issues for risk parity managers as it has for those following illiquid or semi-liquid strategies.

Risk parity can be offered at a relatively low cost, compared to traditional active management. Therefore, fee-conscious investors may find risk parity attractive relative to hedge funds for the absolute-return space in a portfolio.

With an understanding of the assumptions underlying risk parity, the instruments the strategy uses, and some typical risk/return targets, we can now move on to evaluating the strategy on its record and to looking at its potential going forward.

<sup>1</sup> For our analysis, we use 60% Russell Global Index (RGI) and 40% Barclays US Aggregate Bond Index. We refer to this portfolio as “60/40” for the remainder of this article.

<sup>2</sup> There are some instances of using physicals. Some risk parity managers avoid swaps, due to counterparty considerations.

<sup>3</sup> This list of assumptions is based on our discussions with managers of risk parity products.

## CONSIDERING THE HISTORY AND FUTURE OF RISK PARITY AS AN INVESTMENT STRATEGY

With the largest risk parity managers at \$100B+ in assets (as of this writing) and new funds opening and gathering assets, risk parity is clearly gaining momentum among investors. But a number of important questions should be addressed.

### Have funds achieved their targets?

In our review of risk parity managers, we have had the opportunity to evaluate past performance, both live and simulated. In Exhibit 1, we depict simulated returns with the circle and actual returns with the asterisk. The universe of risk parity funds has produced attractive returns relative to the 60/40 portfolio over the last five years, though some have struggled in more recent months. In evaluating risk parity returns, the reader should keep a few things in mind:

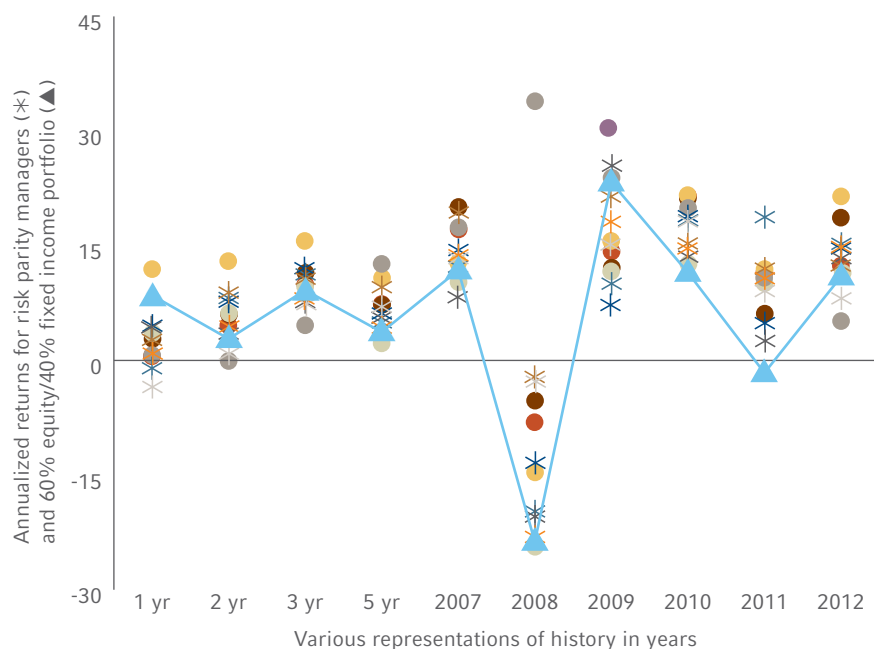
- › Many of the risk parity returns in Exhibit 1 are simulated—they represent what the funds would

have achieved had they existed at the time—but the 60/40 returns are not simulated. Therefore, one might suspect that a live history of each of these 12 funds might not look as pretty as the simulated version.

- › While risk parity returns as a group seem quite attractive relative to those of 60/40, they are by no means homogeneous. The distributions of returns in 2008 and 2009, as well as the most recent 12 months, are particularly broad.
- › Investors should note that risk parity managers may experience drawdowns. For example, risk parity may have outperformed the 60/40 in 2008, but the returns were often quite negative. As well, some funds have negative returns for the most recent 12 months.
- › Risk parity's relatively high allocation to fixed income (as compared with the 60/40) was a strong tailwind in a falling-rates environment and the

### Exhibit 1: Comparison of risk parity managers<sup>4</sup> with 60% equity / 40% bond portfolio

Distribution of risk parity returns compared with 60% equities / 40% fixed income



<sup>4</sup> Managers included represented ~80% of the assets under management in risk parity strategies as of December 2012.

Asterisks indicate live fund returns. Dots indicate simulated returns. Simulated returns were provided by individual managers. The methodology used by managers may vary, so that returns may not be directly comparable. The returns are shown gross of fees. Please see the disclosure section for limitation of simulated returns. The triangles with a connecting line indicate the 60/40 portfolio. Equities are represented by the Russell Global Index. Fixed income is represented by the Barclays US Aggregate Bond Index.

Source: Russell, Barclays Capital, various risk parity managers.

## INVESTMENT FOCUS (continued)

expectation of tapering in May and June of 2013 became a headwind. When equity performed well in 2009, the 60/40 outperformed 75% of the risk parity funds. Bill Madden has shown that a typical risk parity portfolio might be expected to beat 60/40 when fixed income beats a mix of roughly 20% equity and 80% cash.<sup>5</sup>

### What are Russell's expectations for risk parity going forward?

We used Russell's strategic planning assumptions to construct a forecast

of risk parity. We compared five portfolios—60/40, frontier tangent, minimum risk, equal-weighted and risk parity. We have constructed a plain-vanilla version of risk parity that considers only the volatility of each asset class, and not its covariance structure vis à vis other asset classes. In this analysis, we employ Russell's 10-year forecast as of March 31, 2013, and include global equities, U.S. aggregate bonds, collateralized commodities futures, U.S. TIPS, global high yield, emerging market debt and a "risk-free rate."<sup>6</sup>

### Exhibit 2: Risk parity compared with other options, unlevered and levered, that seek to meet either equal risk or equal return expectations

	ALLOCATIONS							SUMMARY STATISTICS		
	EQUITY	FIXED	CCF	TIPS	GHY	EMD	RFR	ER†	STDEV	SHARPE
<b>UNLEVERED</b>										
<b>RP</b>	5%	45%	6%	26%	8%	11%	—	1.87%	2.94%	0.63
<b>Tangent</b>	3%	91%	1%	2%	2%	1%	—	1.68%	2.10%	0.80
<b>Min Var</b>	0%	84%	1%	18%	-1%	-1%	—	1.33%	1.87%	0.71
<b>1/N</b>	17%	17%	17%	17%	17%	17%	—	2.80%	6.00%	0.47
<b>60/40</b>	60%	40%	0%	0%	0%	0%	—	3.84%	10.89%	0.35
<b>LEVERED TO EQUALIZE 60/40 STANDARD DEVIATION EXPECTATIONS</b>										
<b>RP</b>	18%	166%	21%	95%	29%	39%	-270%	6.91%	10.89%	0.63
<b>Tangent</b>	14%	471%	6%	8%	12%	6%	-418%	8.68%	10.89%	0.80
<b>Min Var</b>	2%	485%	5%	104%	-9%	-6%	-481%	7.74%	10.89%	0.71
<b>1/N</b>	30%	30%	30%	30%	30%	30%	-81%	6.38%	10.89%	0.47
<b>LEVERED TO EQUALIZE 60/40 EXCESS RETURN EXPECTATIONS</b>										
<b>RP</b>	10%	92%	12%	53%	16%	22%	-106%	3.84%	6.04%	0.63
<b>Tangent</b>	6%	208%	3%	4%	5%	3%	-129%	3.84%	4.81%	0.80
<b>Min Var</b>	1%	241%	2%	51%	-4%	-3%	-188%	3.84%	5.40%	0.71
<b>1/N</b>	23%	23%	23%	23%	23%	23%	-37%	3.84%	8.24%	0.47

Source: Russell.

†Excess return over risk-free rate.

CCF=Collateralized Commodities Futures; TIPS=Treasury Inflation-Protected Securities; GHY=Global High Yield Bonds; EMD=Emerging Markets Debt; RFR=Risk Free Rate.

Data provided for illustrative purposes only and is not meant to represent any actual portfolio/investments.

<sup>5</sup> Madden, William (December 2012), "Estimating the conditions for return equality between risk parity and a traditional 60/40 portfolio," Russell Practice Note.

<sup>6</sup> We actually use Russell's 10-year cash forecast and ignore the volatility of that forecast. Essentially, we are explicitly assuming that we can borrow with a determinate rate. This is not a strong assumption, since the rate of borrowed funds will not change over time; but the reader should note that the determinate rate at which one borrows will vary with the point of borrowing. That is, while I can borrow today at 2.1% for a 10-year obligation, if I borrow again next week, the rate will be slightly different.

Exhibit 2 allows for a variety of interesting observations.

- › While it is not possible for all institutional investors to use leverage, the practice may enable those who can to move away from relying solely on highly volatile equity for generating asset growth. The equity allocation of risk parity is noticeably lower than that of 60/40.
- › By definition, the tangent portfolio has the highest Sharpe ratio. Risk parity is behind both the tangent and the minimum variance portfolio in regard to Sharpe ratio. However, risk parity requires less use of leverage to achieve potentially equity-like returns.
- › The 60/40 portfolio does offer the lowest Sharpe ratio.
- › Introducing leverage allows for either higher expected returns at an equal level of risk or equal expected returns at a lower level of risk.

#### Does risk parity merit the attention it has received?


In the universe we analyzed, risk parity has offered some very attractive return patterns in recent years. Remember, however, that Russell's strategic forecasts take forward expectations for interest rates fully into account. Combining our consideration of forward rates with the

four observations above, we conclude that risk parity does indeed merit attention and further investigation for investors who are not averse to implicit leverage.

#### What will undo the positive potential for risk parity?

There are some conditions under which the risk parity strategy will come undone.

- › If interest rates rise faster than what is currently priced into the yield curve, risk parity may experience a headwind.
- › If the cost of such leverage rises, or if margin calls require explicit leverage, risk parity may also experience problems.
- › Risk parity relies on diversification among major asset classes. If correlations among these asset classes increase while asset class performance declines, then risk parity will also experience problems.
- › Risk parity requires more frequent trading than does 60/40. Therefore, dramatic increases in the bid/ask spreads or trading costs of futures, swaps or ETFs will present issues for the risk parity fund.

The risk parity investor must either accept that adverse conditions may arise and cause lower expected returns, or be confident in considering these conditions unlikely. 

The simulated returns were derived by the various calculations of the individual managers. The results do not reflect actual trading or the impact of factors that might have affected the manager's decision-making. No market risk was taken during the periods that were simulated. The results may benefit from hindsight and, as a result, almost invariably will show attractive returns. Hypothetical or back-tested performance is no guarantee of future results.

All security futures contracts involve risk, and there is no trading strategy that can eliminate it. Strategies using combinations of positions, such as spreads may be as risky as outright long or short futures positions.

#### Related research:

“Risk parity” by Leola Ross and Steve Murray.  
Available on ClientLINK at <https://clientlink.russell.com>  
or [russell.com/institutional](https://russell.com/institutional).



## CLIENT FOCUS

# Evolving mindset: Three practical steps toward dynamic portfolio management

By: Heather Myers, Managing Director, Non-Profits, and Lila Han, CFA, CAIA, Senior Analyst, Non-Profits



Heather Myers



Lila Han

In a recent non-profit webcast, we surveyed participants and found that 18% of those surveyed have engaged an outsourcing provider for either recommendation or implementation of asset allocation changes.<sup>1</sup> This observation is a significant increase from only a few years ago and parallels a shift happening in the industry to move away from a decision making structure based on quarterly investment committee meetings for approval and implementation of portfolio changes.

A key driver behind this trend reflects institutional investors increasingly embracing the belief that to successfully meet investment objectives, their portfolios need to be dynamically managed. There are many reasons for this: the challenging and changing markets environments; the complexities of the markets, and of regulatory regimes; the dizzying numbers of investment vehicles now available, including technological improvements that allow investors to fine-tune their investment exposures. Even as institutional investors understand that the “set it and forget it” approach to portfolio allocation and management is insufficient, many also understand that their organizations are not currently structured to effectively manage a more dynamic approach.

There is more to all of this than simply telling the portfolio manager to take more active bets. The institutional investor must review guidelines, governance, the allowable levels of manager discretion and the roles of the various fiduciaries. The decision-making protocols will change, as will the way decisions are monitored and evaluated.

In this article we look at these necessary changes in the context of three steps:

- › Roles and responsibilities
- › The investment policy statement
- › Portfolio monitoring

## 1. OUTLINE ROLES AND RESPONSIBILITIES.

It should be obvious—but is often overlooked—that clearly outlining roles and responsibilities in the asset allocation process is critical. In practice, there are many possible models for managing your portfolio. This makes it all the more important to be clear about who is responsible for each task. As you consider taking a more dynamic approach to the management of your portfolio, we suggest that you begin by creating an outline—tailored to your organization—that addresses questions such as:

<sup>1</sup> Webcast. “Creating a dynamic investment policy statement.” September 25, 2013. Total survey respondents included 54 asset owners from various non-profit organizations.



- › Who makes asset allocation recommendations?
- › Who decides whether to approve the recommended adjustments?
- › Who implements portfolio changes?
- › Who oversees the external providers that are now associated with your fund?

Undertaking a more dynamic approach will involve more than a shift in structure; it involves a shift in mindset, which requires discussion and alignment among decision makers. For example, it is currently common for the investment committee of a non-profit organization to approve every portfolio adjustment in its quarterly meetings. If the portfolio is to be responsive to changes occurring at a faster than quarterly pace, the present protocol is clearly too cumbersome. Instead, the committee needs to be willing to delegate that responsibility to its own investment staff or to an outsourcing provider. After delegating that responsibility, the committee will no longer spend part of the limited time available in its quarterly meetings discussing questions such as whether to increase the portfolio's exposure to emerging markets or to engage the services of a specific manager. An effect of this change will be to open more time for the committee to focus on oversight and on strategic issues, such as whether the fund needs to change its annual spending rate. In a complex and changing world, having time to focus on the strategic discussions is all the more important.

There is a fiduciary consideration in all of this, too. You cannot outsource all fiduciary responsibility, but it is good practice to delegate tasks to specialist experts wherever the process can be improved by doing so. In many cases, those specialists will also take on some of the fiduciary duties of the program. It is worthwhile to make sure that you know exactly what level of fiduciary responsibility your investment manager will assume.

## 2. ENSURE THAT YOUR INVESTMENT POLICY STATEMENT ALIGNS WITH YOUR DESIRED APPROACH.

Your investment policy statement (IPS) can help you document the roles and responsibilities associated with your fund. If you are moving toward a more dynamic asset allocation approach, the IPS will need to be updated accordingly. In our webcast survey, we found that almost 60% of respondents felt they did not have a governance structure in place that allows for dynamic portfolio management.

For example, in many organizations, the IPS has specific guidelines for individual asset classes. Moving to a more dynamic approach generally involves allowing wider leeway to change allocations, and can even lead to a redefining of focus—supplementing asset class allocations with asset role allocations—that can enable the flexibility needed in a more nimble portfolio, while still setting guidelines for implementation (e.g., no more than 20% of the total fund is to be invested in assets without daily liquidity). Such changes will need to be captured in the IPS.

Exhibit 1 illustrates what we mean by an asset role approach. This example is derived from Russell's non-profit model portfolios given high liquidity constraints and a return target of CPI + 5%.

Some organizations have developed an implementation document that allows their designated providers to adjust underlying strategies within the same asset role. Such a document allows an organization to make portfolio shifts without obtaining required approvals for updating an IPS, such as shifting between core real estate and other real assets like commodities and infrastructure. Within a total portfolio context, these can all play the role of inflation responsive assets to varying degrees.

The principles for updating an IPS to reflect a more dynamic portfolio management approach include:

- › Be specific about the outcome desired,
- › Identify the roles of the strategies used, and
- › Allow ranges across roles, as opposed to ranges restricted by single-asset-class buckets
- › Allocation shifts should not be subject to the time constraints of quarterly investment committee approval.

### 3. DEFINE AND MONITOR TOWARD YOUR DESIRED OUTCOME.

Before your organization changes its asset allocation approach, discuss your expectations for success: What is your desired outcome? How will you monitor results against those expectations? Recognize that each fund is driven by unique circumstances and unique goals, and that beating a benchmark is not the same goal as reaching a good outcome.

In order to manage to a desired outcome, it is important to be able to manage and measure risk at the total portfolio level. Our webcast survey found that over 60% of respondents are in the

process of adding new risk tools, enhancing existing tools or doing both. The increasing resource allocation to risk tools underscores the importance of having an integrated view of risk at the total portfolio level, which enables timelier trade-offs to be made across asset classes, investment strategies and risk factors to adapt to today's volatile markets. Indeed in volatile markets, unmanaged exposures can cause a portfolio to drift off track and consequently, reduce the likelihood of achieving the desired outcome.

Successful investment begins with a focus on clear goals. A dynamic approach to portfolio management can help to meet these goals. Building such a dynamic approach into an investment program means revisiting things like the Investment Policy Statement and the overarching governance structure, appropriately define roles for all of the portfolio's fiduciaries. As with all aspects of a well-run investment program, a proper governance structure is essential. ■

### Exhibit 1: Comparison of traditional asset class approach with a sample roles framework

TRADITIONAL ASSET CLASS APPROACH:	TARGET	RANGES
US Equity	22.0%	15%–25%
International Equity	23.0%	15%– 28%
Emerging Markets Equity	5.0%	0%–10%
Fixed Income	10.0%	5%–15%
Real Estate	11.5%	7%–14%
Real Assets ex Real Estate	10.5%	7%–14%
Marketable Alternatives	15.0%	12%–18%
Private Equity	3.0%	0%–5%

Notes: Asset classes typically included in each portfolio role are (representative not exhaustive list): Growth—public equities, return-seeking fixed income such as high yield and long/short equity hedge fund strategies; Return Enhancement—less liquid growth strategies such as frontier market equities, distressed debt and private equity; Inflation Responsive—private core real estate and marketable real assets; Risk Reduction—U.S. core fixed income, global fixed income, low volatility hedge funds, and tail-risk hedging strategies. Some investment strategies may serve more than one portfolio role.

### Sample roles framework incorporated into an IPS

Portfolio role	Anchor target	Approved ranges	Liquidity profile
Growth	55%	40%–65%	Daily liquidity
Return enhancement	10.5%	8%–18%	Daily liquidity to illiquid
Inflation responsive	22%	15%–28%	Daily liquidity to moderately liquid
Risk reduction	12.5%	7%–15%	Daily liquidity to moderately liquid

## OPINION

# A “good enough” 401(k) plan isn’t good for participants’ retirement security

By: Richard Davies, Managing Director, Defined Contribution

Shortly after passage of the Pension Protection Act (PPA) of 2006, I had a memorable conversation with a company treasurer. After I suggested that he take advantage of the Act’s fiduciary protections to enhance his defined contribution (DC) plan participation, he curtly replied, “Dick, you just don’t get it, do you?” the treasurer fumed. “I’m not trying to run the best 401(k) in America—it just has to be good enough.”

I’ve come to observe that “good enough” is indeed good enough for many companies. But “good enough” isn’t working for many plan participants. Why is this so?

We live in a nation in which 69% of private sector workers with some type of workplace retirement program are depending entirely on their DC plan—plus Social Security—to meet their retirement income needs.<sup>1</sup> However:

- › **Many eligible employees aren’t saving at all.** Record keeper statistics indicate that nearly a quarter of eligible workers do not enroll in their company-sponsored retirement plans.<sup>2</sup>
- › **Savings are insufficient.** Most consultants agree that workers must consistently save 15% of their earnings to support themselves in retirement. However, average savings rates have been stable at about 7%—add in a typical company match, and we get to about 11%. But averages are misleading. Roughly a quarter of participants are saving less than 4% before the match.<sup>2</sup>
- › **Most participants are poor investors.** When we use target date fund design as a marker of appropriate allocation, we can see that it’s not unusual for 70% of participants to have an inappropriate mix of stocks and bonds in their portfolios.<sup>2</sup>

The solution is quite straightforward, and the PPA provides a road map:

- › **Auto-enroll new employees and all non-participants every year.** And not at the typically cautious 2%–3% contribution levels, but at 5%–6%. Admittedly, this will mean some additional expense.
- › **Auto-escalate employee contributions from initial rates by 2% per year to 10% or higher.** Stretch the company match formula, if necessary, to support higher savings. For example, instead of a dollar-for-dollar match on the first 5% of contributions, match 50% on the first 10%.
- › **Encourage participants to move their assets into the default portfolios blessed by the Act—typically, target date funds.** Education alone will not do it—re-enroll participants by use of a “negative consent” process.

Following these steps, we’ve seen that some plans have boosted participation rates to 95%–98%; have seen total savings (participant plus company match) for the majority of participants approach 15%; and have moved 80% of assets into professionally managed portfolios, with these gains largely benefiting workers of low and moderate income.

Offering a “best-in-class” plan can have a significant impact on participants’ retirement security—and ultimately, that’s the “good” that matters most to fiduciaries. ■



Richard Davies

<sup>1</sup> Employee Benefit Research Institute. “FAQs About Benefits—Retirement Issues.”

<sup>2</sup> “How America saves 2013: A report on Vanguard 2012 defined contribution plan data.” Vanguard. June 2013.

## Q&amp;A

# Who does what? Outsourcing versus the in-house management model

With: Michael Thomas, CFA, Chief Investment Officer, Americas Institutional



Michael Thomas

## Outsourcing, or OCIO, is clearly evolving, but can you describe what outsourcing means in our industry today and, in particular, how Russell approaches it?

Outsourcing boils down to the delegation of the day-to-day management for all or a portion of a portfolio. There is more than one way to divide responsibility for the many tasks that go into running an institutional investment program. There are certain things that only the client can do and certain things that always fall squarely into Russell's areas of responsibility. But there are some other tasks where the decision is going to depend on whether the client is looking to delegate as much of the investment process as possible or whether they want a more consultative relationship, retaining more of the day-to-day duties in house.

## Can you give some typical examples of activities that are delegated in an outsourcing relationship?

Manager selection and fee negotiations are the most obvious examples, but it goes much beyond that to include, for example, tactical tilts around a policy target; dynamic use of both active and passive management; and daily risk management, including the use of risk-completion plugs. These all fall into the list of investment activities that are often delegated. We also see the delegation of operational activities, such as the monitoring of funded status and adherence to a glide path and the management of cash flows into and out of the portfolio.

## Is there anything that can't be outsourced?

Yes. While Russell acts as a co-fiduciary in every outsourcing relationship, plan sponsors retain their fiduciary obligations—which means they continue to conduct governance oversight. Their focus, however, shifts. For example, rather than approving things such as manager changes or tactical tilts (which are really daily portfolio management decisions), an outsourcing client's focus shifts to ensuring that the OCIO's decision-making and implementation processes remain sound.

Another example is asset allocation. While Russell is often given some discretion around strategic asset allocation, our clients ultimately approve policy targets—because strategic asset allocation is a direct reflection of risk tolerance, and risk tolerance is unique to each investor.

## So the plan sponsor retains a hands-on role in many ways?

Absolutely. In fact, "outsourcing" is not the best term for these relationships. It's more an extension of staff, whereby our clients focus on the "long lever" decisions and we focus on the day-to-day implementation of these decisions.

### How do these relationships typically start? Is it a flip of the switch, or more of an evolution?

We've seen both, but it's more common for relationships to evolve toward outsourcing. For example, we might start by assuming responsibility for a client's liability-hedging portfolio and over time assume more discretion over their return-seeking portfolio as well.

### Why is the outsourcing approach gaining momentum?


It really boils down to the world getting more complex and resources being squeezed. Mark-to-market accounting has made the penalty for getting things wrong much more costly, which has translated to investors looking to delegate some tasks so that they can focus on getting the big picture right.

### When might an investor choose not to delegate as much as possible?

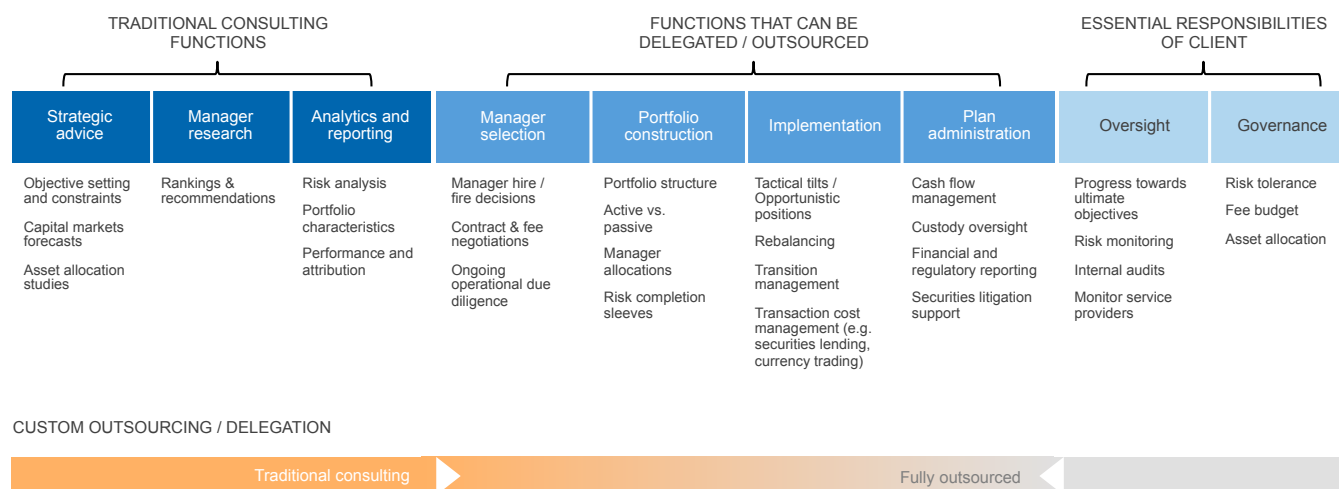
A lot of this has to do with scale. Very large organizations have the option of

building an investment staff to take care of many of the day-to-day tasks that smaller and medium-size funds have little choice but to delegate. It also has to do with how much time is left after they have given full attention to really understanding and articulating their objectives, constraints, fee budgets, risk tolerances and so forth.

### And, finally, what is next in this area?

Well, you never know for sure. But the defined benefit and non-profit sectors both continue to mature. Resources continue to be stretched. The investment world continues to get more complex. So the conditions that have led to an increase in outsourcing seem set to persist. We expect this to mean that the practice will continue to gain ground, even among some of the larger plans that might not have considered it in the past. 

## Exhibit 1: Functional responsibilities overview



# 1735 to 2013: Platinum evolves from grapeshot to great hope for debtor nations

By: Aran Murphy, Director, Business Strategy



Aran Murphy

In modern times, platinum is considered the most precious of precious metals. But it was not always so. Earliest archaeological uses of the metal—from the Casket of Thebes of ancient Egypt (700 BCE) to the sintered<sup>1</sup> jewelry of the Esmeraldas peoples of Ecuador (hundreds of years before the Europeans came to the Americas—were remarkable for their rarity. Few cultures throughout history demonstrated knowledge of platinum.

Later uses of platinum, such as the adulteration of gold coins by counterfeiters, or even the use of platinum as cannon grapeshot, suggest the low value placed on the metal. The name for platinum itself, *platina*, is a diminutive of silver (it means “little silver”). While gold and silver enjoyed near-universal appreciation, platinum was considered a nuisance metal when it was known at all.

Relative to gold or silver, platinum is geographically rarer. It is also much more difficult to work with. It is denser than gold, and nearly twice as hard. Platinum’s melting point is three times higher than that of gold. Despite the ingenious sintering work of the aforementioned Esmeraldans, it was not until the late 18th century that Europeans could effectively melt and work with the metal.

From 1735, when science first recognized platinum as an element of its own, its uses grew. Now it is used everywhere, from refining oil to scrubbing pollutants to helping fight cancer.

Platinum’s extreme usefulness in science was about to take on a near miraculous turn in politics. Some proposed that platinum would solve the problem of crippling government debt.

In 2011 through 2013, the U.S. federal government faced a series of budget showdowns. Revenues were lower than expenditures, and the government’s ability to borrow periodically hit against a self-imposed debt ceiling. The logical choices were to cut expenditures (unpleasant), raise taxes (even more unpleasant) or find some messy compromise in between.

One political commentator suggested a solution: why not have the U.S. Treasury strike a trillion-dollar platinum coin, and deposit it in the Federal Reserve Bank? A loophole in the law authorizing the U.S. Mint to strike platinum coins does not specify denominations. With a trillion-dollar platinum coin on deposit at the Fed, the U.S. government could then have something to draw on, and could avoid the need to issue more debt.

Platinum is an amazing metal. But it is not *that* amazing. Fortunately for the credibility of the U.S. dollar, the president and the Treasury did not believe that striking a trillion-dollar platinum coin would solve the U.S. government’s fiscal problems. The idea quickly faded in favor of more credible budget compromises. Platinum, a metal that was once considered a nuisance metal, was not to become a trillion-dollar ploy for avoiding hard governance decisions or the philosopher’s stone for unlimited government finances. ■

<sup>1</sup> Sintering is a metallurgical process of molding powdered metal at a temperature below the melting point, a process made possible by atomic diffusion.

Primary source: History of Platinum and Its Allied Metals, Donald McDonald and Leslie B. Hunt. Published by Johnson Matthey (London), 1982. Text available for download online at <http://www.platinummetalsreview.com/resources/history-of-platinum-2/>.

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“Alpha mapping and the intelligent consumption of active management” noted that higher benchmark concentration was associated with higher alpha. The article has since been corrected to note that higher concentration was associated with lower alpha.

In addition, the statement, “higher returns dispersion was associated with lower alpha (and so the average manager alpha is generally lower in markets with higher return dispersion)” has been removed. The average manager alpha has historically been higher, not lower, in markets with higher return dispersion. However, in a multi-variate setting, this relationship becomes more complex as those same markets also tend to exhibit other characteristics associated with high alpha potential, such as low broker coverage.

An updated version of this article is available by request.