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A BRIEF GUIDE TO INVESTMENT MANAGEMENT OR EVERYTHING YOU ALWAYS WANTED TO KNOW ABOUT ASSET MANAGEMENT

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With assets under management in the region of global GDP, or USD 35 trillion, investment management or delegated management is central to the financing of modern economies, in which risk is increasingly being transferred amid a proliferation of financial innovation. However, from an institutional point of view, this branch of industry remains relatively unknown or is often associated with a single product: UCITS (SICAV or FCP). This inspired us to write this brief guide as an attempt to respond to those who are seeking to understand the terminology and tricks of a trade in which, besides the technical aspects of the management process, the personality of the manager plays a fundamental role. Minimalist and in no way exhaustive, this brief guide describes and, in some cases, defines the basic concepts, highlights the existence of techniques or innovations specific to the industry and explains, where appropriate, some of the main characteristics of delegated management versus other financial activities. In short, the aim of this essay is to outline, on a very modest scale, several key factors that we feel are vital to understanding a booming industry employing more than 30,000 people. The dynamic nature of asset management companies and the rich network of relationships they maintain with suppliers, distributors and their control environment has led to the specialisation of a number of functions, each with its own terminology, which is often borrowed from English.

We hope that this guide reflects this vitality and richness and enables all those interested in this key industry to discover its basic terminology. This guide is structured around thirty or so thematic entries and an index. Like any guide, it may be dipped into at will, but we recommend that readers, particularly those with less experience of the industry, start with the entry “investment management” or “management companies” so that they can understand some of the institutional characteristics of the industry from the outset.

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Alternative management *or the story of a counter-culture*

A genuine source of non-conformity, alternative management is often defined in opposition to traditional management approaches, in which portfolios are most often benchmarked and/or index-linked. Established by managers who reject the "Markowitzian" assumption of the informational efficiency of markets, alternative management is not so much a management technique as a set of strictly active management strategies, whose main objective is absolute performance, often – but not necessarily – decorrelated from the rises and falls of the market. Most often developed by trading floor professionals, according to Lhabitant (see this edition of REF) alternative management has more in common with stock-trading culture than asset management. This gives rise to a number of characteristics, in particular a tendency to be more flexible than conventional approaches in terms of combining long and short positions, aggressive use of derivatives – both classic and credit – and leverage[1], legal structures and tailor-made products, etc. The taxonomy of alternative management is rich and constantly changing and varies from sponsor to sponsor. That said, it is possible to identify at least four groups of strategies (each with a number of sub-strategies): *long/short equity*[2]; *event driven*[3]; *arbitrage*[4]; *trading*[5]. Whatever strategy is adopted, alternative management most often takes the form of hedge funds (85% of alternative outstandings worldwide). Other alternative management vehicles include *private equity funds* – venture capital, development capital, etc - (Lhabitant, 2004).

AMF classification *or a way of reflecting the risk exposure of UCITS*

In order to inform customers about the risk exposure associated with their dominant underlying and for comparison purposes, all *UCITS* are categorised by the AMF. This information must be included in the product's marketing material. Thus, the AMF distinguishes the following categories and sub-categories (in brackets) of UCITS: equities (French, euro zone, European and international), bonds (euro zone and international), money-market (euro zone and international), diversified, formula funds and alternative funds of funds. Of course, there are many other categories, most of which are created by commercial companies specialising in *performances* measurement and/or *rating* companies such as Europerformance, Standard & Poor's and Morning Star, etc.

Asset allocation *or the story of a multi-stage rocket*

Asset allocation[6] corresponds to the first two stages of any *management process* (whether *diversified management* or specialised management). The first act, strategic allocation, which generally precedes any delegation of management powers, consists of breaking a portfolio down into major *asset classes*. It largely depends on the investor's investment horizon and assessment of risk (or risk aversion). The following phase, tactical allocation, basically comprises research, analysis and management procedures. Depending on the way the management company in question is organised, managers, analysts and traders[7] - often accompanied by strategists and economists – meet in an investment committee to decide which industries, stocks and maturities to emphasise or reject based on the central scenario and the specific features of each stock. In the third stage, they build the actual portfolio using *stock picking* or the selection of one or more indices. A specific portfolio is built for each fund, taking into account the objectives and constraints of the investment committee. Then, the manager modifies the portfolios according to the committee's expectations and the recommendations of analysts.

Asset classes *or the building blocks of asset management*

The types of securities or other financial instruments that a fund invests in: equities, bonds, *derivatives*, money-market instruments, property, commodities, etc. *Alternative management* funds are sometimes likened to asset classes, whereas it is more a question of techniques or, more precisely, management strategies.

***Autorité des Marchés Financiers* (AMF)** *or France's investor watchdog*

In France, financial regulation is overseen by the AMF, an incorporated independent public authority. As well as registering and approving investment managers, asset management companies and investment service providers (ISP)[8], the AMF is responsible for safeguarding savings invested in financial products, and any other investment giving rise to a public offering, overseeing investor information and maintaining orderly financial markets. Its activities are often developed in conjunction with management professionals.

Average return of a UCITS *or measuring the performance of investments between two dates*

Return expresses total gain or (loss) over a given period. As such, it measures changes in the value of a portfolio. For an investor, it depends on the start and end dates of the investment or the dates on which he or she buys and sells fund units. The rate of return is a percentage incorporating capital gains or losses on all asset classes plus, where appropriate, dividends for shares and interest for fixed-income products. Since the rate of return is variable (aleatory), we are interested in its average and its standard deviation or volatility. The average return of a portfolio is the weighted sum of component asset returns.

Benchmark *or the basic need for investment yardsticks*

The "pilot fish" of "relative performance" approaches, the benchmark is an index or combination of indices used to measure the *return* of an investment against a predetermined target (for example the performance of the CAC 40, the S&P 500 or a basket of stocks or indices). When the benchmark constitutes an investment objective, it must be spelled out in the prospectus issued to subscribers to the fund. A ratio known as a *tracking error ratio* is usually defined as part of the management of the portfolio. The tracking error ratio indicates the probability that the fund's performance will deviate from that of its *benchmark*. The closer to zero the ratio, the more closely the fund is tracking its *benchmark*. For example, an equity index fund will, as a general rule, have a *tracking error* of 1% to 2% maximum. (Aftalion and Poncet, 2003; Boulier and Dupré, 2002).

Compliance *or how the profession contributes to market discipline*

Compliance is the function that aims to ensure that the contractual, legal and regulatory requirements of asset management are adhered to. An obligatory function in French *portfolio management companies*, the mission of the compliance officer is essentially to implement, oversee and control the rules of professional conduct. He or she is also responsible for advising and educating operational units and heads of management companies as well as coordinating with external control. The compliance officer oversees the enactment of the Compliance Code established by the profession or the establishment itself. The AFG[9] has been enacting compliance rules specific to various types of UCITS and mandates for over 15 years. Approved by the AMF and regularly updated, these codes encourage self-discipline among members of the profession. As stock exchange rules, they must be observed by all industry players whether or not they belong to the association.

Corporate governance *or how asset management forms an opposition power*

Corporate governance relates to a more general movement to "tame" the behaviour of economic agents from an investor's point of view, but is fundamentally expressed in the search for ways of exercising and encouraging the exercise of shareholder rights. AFG compliance rules and AMF law and by-laws state that voting rights attached to UCITS assets must be exercised and the fund administrator is obliged to report on its practices in the matter in the fund's annual report. The AFG has taken at least two steps to facilitate the exercise of voting rights: it adopted a body of recommendations on corporate governance relating to shareholders' meetings and boards of directors in June 1998 and set up a watch programme for SBF 120 companies in 1999. This programme seeks to draw the attention of investors, represented by fund administrators and more particularly management companies, to the draft resolutions made by shareholders' meetings (SM) of companies included in the SBF 120 against the recommendations of the AFG and encourage them to take an active part in those meetings. Specifically, this programme aims to help managers exercise their voting rights in accordance with Compliance Codes and as required under the financial security law (Bollon, 2001; Hellebuyck and Vlaisloir, 2004).

Depositary *or the story of an effective investor safeguard*

Among the regulatory mechanisms that have been put in place to safeguard UCITS investors, the depositary is fundamental (see diagram in the appendix). The depositary is invested by law with two main missions: asset custody and compliance monitoring for *UCITS* and *management companies*. In accordance with the principle of safekeeping, sums and assets assigned to management companies are held by a depositary[10] and not by the company itself. This allows clear identification of the property or capital of the management company and assets belonging to investors. Thus, in the event of default – for example as a result of operational failure – losses are borne by the management company first and foremost, rather than the investor. General practice in European countries requires the separate management and custody of assets in legally distinct institutions or, failing this, the compulsory segregation of assets. Compliance monitoring by the depositary concerns essentially compliance with investment rules, which are listed in the simplified prospectus, capital ratios, UCITS classification and NAV calculations, etc. All in all, in exchange for the payment they receive for their services, depositaries are subject to a number of constraints and responsibilities that make them effective in controlling transactions and distributing the risk described in the prospectus.

Derivatives (products) *or one of the tools driving portfolio risk management*

A derivative instrument is a financial contract relating to a financial asset (the underlying) made between two parties on the over-the-counter or organised markets. Two categories of contract exist: future (or *forward*) contracts, which are promises to buy (or sell) in the future, and options (or *warrants*), which are conditional. Portfolio managers use derivative products in several circumstances: for portfolio exposure (Future CAC 40 for example pending security investment) or hedging purposes (future dollar sales to hedge foreign exchange risk) or so that money is made not only when the market goes up (long *call* on equities in structured funds). Derivative products have developed considerably in the financial markets over the past 30 years having started out from commodity, metal, oil, agricultural, weather and other contracts. In 2005, notional amounts total around USD 150 trillion. Fixed-income instruments account for the biggest volumes (interest rate *swaps*), but equities, currencies, credit (including credit derivatives) and others are also involved. All categories of funds can be used in this way, including cash funds, in order to manage interest rate risk, but this use may be subject to certain regulatory constraints. For example, it may have to be made clear in the prospectus or a commitment ratio may apply, etc (Boulier and Dupré, 2002).

Discretionary management mandate *or the delegation of security management*

The management mandate (except for collective management, see table in the appendix) is a civil law contract drawn up upon agreement between the administrator and his client, either *de visu* for individual clients or, most often, after competitive bidding in the case of institutional investors. The management mandate is a contractual document, although certain clauses must be included. In France, it must include the following information: the capacity of the principals; the investment universe and management objectives; *benchmark(s)*; details concerning the remuneration of authorised agents; the instruments used and, where relevant, specific authorisation to trade on the *derivatives* market; methods of financial *reporting* – which must occur at least quarterly, if not monthly where derivatives are used; and performance measurement routines, etc.

Diversified management *or the art of diversification using risk profiles*

Diversified management builds portfolios composed of the main *asset classes,* which may in turn be diversified by geographic region, by sector, by theme, by *management style* and, in the case of fixed-income products, by maturity. This usually involves portfolios with a predetermined risk profile, such as conservative, balanced, dynamic or aggressive profiles[11]. The typical process associated with this type of management can basically be broken down into five stages: investment strategy (strategist opinion on major asset classes based on macroeconomic analyses), investment policy (senior investment managers decide the general focus of the investment in terms of asset classes), asset allocation for model portfolios (managers build model portfolio families), personalised asset allocation (portfolios adapted to the constraints of customers) and the construction of the diversified portfolios (the contributions of specialist managers are brought together in the diversified portfolio). Unlike diversified management, specialised management focuses on a single asset class (equities, bonds, etc). In this case, the management process comprises both asset allocation (strategic and tactical, i.e. sub-asset weightings) and *stock-picking* (Mathis, 2002).

Due Diligence *or how to guarantee the quality of the manager*

Due diligence involves quantitative and qualitative analysis, generally conducted by the institutional investor before any relatively complex investment is made. It involves the minute examination of the main constitutive elements of a fund or management company: balance sheet, income statement, strategies and management styles and the manager's track record, etc. Meetings with the manager (or fund administrator) and his teams are also vital (Capocci, 2004; Lhabitant, 2004).

Fees and charges *or small payment for delegated management services*

Clients, whether institutional investors or individuals, generally pay four types of charges directly. Front-load charges (or subscription fees), which may be either fixed or a sliding percentage of capital (or net assets), are paid to distributors upon purchase of fund units or shares. Most of the time, they are used to pay the retail networks. Management fees are deducted over the life of the contract. They are expressed as a percentage of net assets and vary according to management style. They pay for the management of the fund. Redemption fees, although increasingly uncommon, may be deducted, usually as penalties, when the client does not fulfil his or her commitments in terms of the period of investment (for example in the case of formula or guaranteed funds, where a certain level of return is contractually guaranteed by the broker). More specifically, and especially in the case of *alternative* management, investors may pay managers a performance-related fee.

Finally, it is important to note that a portion of the commission paid by the funds may be retroceded to management companies. This basically involves transfer fees or stock-trading fees, which are based on the trades transacted by the management company on behalf of the fund.

Financial management styles *or from classic to alternative*

Four types of products or management approaches may be identified for pedagogical purposes: classic, alternative/structured and those based on *multi-management* approaches.

Whether specialised or diversified, classic management generally uses a *benchmark* and makes limited use of more complex techniques or financial instruments such as classic and credit derivatives, leverage and short selling. Structured management basically comprises guaranteed-capital products (see *Product ranges*) and formula funds, which are linked to the performance of an index or a group of securities and promise high income (for the two other management styles see *Alternative management* and *Multi-management*).

Financial solicitation and marketing *or how to increase the accountability of the distribution and consultancy industries*

Financial solicitation consists of visiting people's homes or workplaces or going to public places to give advice on the subscription, purchase, exchange or sale of securities or participation in related deals. The offering of services or the giving of advice by letter or circular or over the telephone are also considered to be solicitation activities. The law relating to solicitation has undergone reform, which has formed the backdrop for the emergence of financial investment advisors (CIF) in France – professionals who commonly give advice on investment services, wealth management consultancy or deals involving banking or financial instruments. This recently regulated profession requires registration with the AMF, and CIFs must take out professional civil liability insurance, belong to a representative professional association, and so on. CIFs will join the list of people authorised to carry out solicitation while bearing liability for advice given.

Informational efficiency *or the story of a concept that shapes manager behaviour*

According to this theory, all market information is sooner or later priced into assets. However, the abundance of information and the number of active investors makes the markets unpredictable in the short term. Therefore, it is impossible to guarantee that an investment will beat the market. In the long term, however, returns on various asset classes are proportionate to risk. Nevertheless, market prices may temporary deviate from their equilibrium levels based on financial rationality. This is particularly true during crises or fads. That said, the theory of the informational efficiency of markets is central to a full-scale quarrel between two schools of thought… or rather two and a half. In simple terms, the champions of pure index management believe that the markets are efficient and that there is little to be gained from stock-picking; conversely, advocates of active management in the strict sense of the term (i.e. alternative management), who quite obviously reject the idea of market efficiency, insist that managerial talent not only allows market opportunities to be exploited but also facilitates price discovery. Because life is complicated, those who favour active benchmarked management, i.e. enhanced index investment (see Investment Policy) fall between the two schools and in fact occupy a vast middle ground. It is in this context that some authors refer to *alternative* *management* in terms of “dissident” strategies that do not measure performance against any sort of index, standard or *benchmark* (Jacquillat and Solnik, 2002; Walter, 1996).

Insurance portfolio *or how to preserve invested capital by limiting capital loss*

A management technique in which the value of the fund is kept above a guaranteed minimum. Because it truncates the distribution of total returns on the left-hand side, this technique aims both to limit loss risk and maintain a portion of positive return.
(Boulier and Dupré, 2002).

Institutional investors *or structural lenders*

Institutions or organisations, generally incorporated, which have a structural surplus and regularly invest capital in the financial or property markets and, increasingly, outsource the management of these investments. They include pension funds, insurance companies, retirement plans, mutual insurance companies, and to a degree, asset management companies via UCITS. Some organisations, including the OECD, include credit institutions in this category. In France, institutional investors hold assets whose end-holders are households, hence the coining of the term “instividuals”, a concept that includes households and a significant portion of assets held by institutional investors on their behalf. Thus, households directly own less than 20% of UCITS net assets on the French market (EUR 190 billion out of a total of EUR 1,100 billion) but their market share is 65% of assets managed in the form of UCITS (or EUR 700 billion) if both direct holdings and indirect holdings via institutional investors are taken into account.

Investment management *or the delegation of a complex function*

From an economic point of view, investment management is defined as the delegation of the investment function[12] and the management of capital and savings by a large number of diffuse agents, whether private or *institutional investors*, to a specialised entity, the *management company* (see diagram in appendix), in exchange for payment (management fees, front-end charges, etc). Indeed, asset management offers investors *diversification* of risks via the expertise of professionals, efficient access to markets with economies of scale and management techniques that most investors are usually unable to access directly. Furthermore, investment management has a legal basis in the management mandate[13] and operates within a strict legislative and regulatory framework, which is gradually evolving from the notion of product to the notion of integral financial intermediary, with the *portfolio management company* (PMC) representing its most current institutional form. While PMCs are a key element of the financial management industry, other players also contribute to the effective functioning of the management process and the competitiveness of the industry. Indeed, the investment industry has a symbiotic relationship with a whole network of professions: *depositaries*, custodians, statutory auditors, valuers, *performance* measurement and attribution teams etc, to name just a few. Teachers and researchers in economics and finance as well as regulators and law specialists are also part of the asset management “ecosystem”.

Investment policy *or the debate over the “social function” of managers*

The investment policy is the management objective of the portfolio. It describes in a stylised manner the rules governing major changes to the composition of the portfolio. Apart from the strictly passive *buy and hold* policy (see Rebalancing), there are essentially two types of investment policy. (Pure) index management seeks to replicate a pre-selected index that represents the target market.

Contrary to conventional wisdom, there is nothing passive about this type of management, which tries to maintain a portfolio composition that is close or identical to the benchmark. Although *rebalancings* are "automatic", the manager plays an "active role" in the selection of indices. Conversely, an active management policy (in the strict sense of the term) refers to rebalancings conducted by the manager based on his own criteria. These approaches are essentially based on the following techniques: *top-down, bottom-up, portfolio insurance,* relative value allocation and tactical asset allocation (TAA), etc. The various types of alternative management, including *hedge funds,* belong to the group of active management approaches par excellence. In reality, a whole rainbow of "mixed" investment policies lies between the two "pure" models mentioned above (index and active). For example, while an *enhanced index fund* tries to beat the index while limiting risk (notably by introducing a small dose of *stock picking*), some active approaches select the *benchmark,* thereby departing from the basic principle of this type of management to some degree.

Management process *or the art of management reduced to a formula*

In response to requests from institutional investors and consultants in charge of selecting managers, management teams have tried to describe their investment methods in the so-called "management process". This document describes the investment universe, the management philosophy, the principal decision-making stages leading to the building (or modification) of the portfolio, and the monitoring and control of portfolio risk and performance. On the one hand, it outlines upstream research, the translation of this research into portfolio exposure and, on the other hand, the human resources and information systems applied. A basic classification identifies two typical processes: *diversified management* (or profiled management) and specialised management.

Management styles *or the impact of the business cycle on managers' convictions*

A concept that is closely but not exclusively linked to equity management. Style-based equity portfolio management consists of selecting stocks on the basis of certain pre-established criteria, the most common of which today are value analysis, market capitalisation and the persistence of performance. Out of these three dimensions come three basic style pairs, which tend to be more complementary than contrasting: *value* or *growth*; *small cap* or *large cap*; *momentum* or *contrarian*.

In terms of value-based styles, the *value* manager focuses on stocks that he considers to be undervalued relative to fundamentals such as earnings, net book value, turnover, etc. This style tracks stocks whose potential has not yet been discovered by the market and which are often overlooked by analysts. The growth manager, by contrast, will prefer well-known stocks whose prices are already high but which have strong underlying earnings forecasts. Some managers specialise in either mid and small caps, which are often illiquid and poorly researched by analysts, or large caps, which are extensively analysed and included on the major indices. Finally, based on a cyclical and, more specifically, opportunist approach, some managers focus on the persistence of performance. *Momentum* managers gamble on stocks, market, sectors, indices and styles themselves based on their recent performance and maintain their positions as long as the trend continues in their favour. Conversely, *contrarian* managers position themselves against the trend in the hope that prices will return to average, by avoiding stocks that have achieved sustained outperformance (either selling them or not buying any more) and favouring stocks whose prices have fallen by a sufficient amount. In addition to these "pure" style pairs, there are of course a number of hybrids or combinations of styles (*growth/momentum, value/large cap, growth/mid cap,* etc), or styles containing a bias corresponding to the degree of intensity required by the managers (*aggressive growth*, etc).

Ultimately, managers adopt a particular style in order to build a portfolio whose return/risk ratio surpasses the market or other management styles. Management styles also facilitate personalised investment and performance comparison (Lhabitant, 2004; Mathis, 2002).

Modern portfolio theory *or the tribulations of a contested theory*

Modern portfolio theory developed out of the work of Markowitz (1952), who was the first to formalise the idea that asset choice decisions demand a trade-off between expected return and risk. This method uses the concept of the efficient frontier, which is a risk-reward curve on which a large number of portfolios of equal efficiency can be constructed. This frontier defines optimal portfolios for investors with different levels of risk aversion. Among the four basic assumptions of the Markowitz model, apart from the idea that the future return of any financial asset follows a normal law of distribution, the assumption that all investors have a single-period investment horizon is fiercely disputed. In fact, since this model is static, nothing happens between the initial moment when the allocation decisions are made and the final moment when the assets are sold at market price. Dynamic allocation models, à la Samuelson-Merton, which are admittedly much more complex, have been put forward since the 1970s in order to overcome the restrictions of Markowitz-style static allocation models. Finally, it is important to note that the key concept of modern portfolio theory is *informational efficiency*, a notion that is no less controversial and currently marks the “dividing line” between index or benchmarked approaches and strictly active management, including *alternative management* (Amenc and Le Sourd, 2003; Jacquillat and Solnik, 2002; Walter, 1996).

Multi-management *or reinforcing “diversified” positions*

Multi-management consists of selecting the best funds and/or managers and bringing them together within the same investment vehicle. Whereas traditional *diversification* is concerned with asset classes, country and sector, etc, multi-management focuses on two “new” methods of diversification: the diversification of management styles in the form of a fund of funds, a product that invests all or part of its assets in the best funds; and manager diversification consisting of the selection not of other funds but of investment professionals to manage all or part of a portfolio in order to build a “managers of managers” product.

Performance *or the best way of measuring return/risk ratios*

Term often misused to mean *rate of return,* in its wider sense performance is a synthetic indicator incorporating the two main dimensions of the portfolio: *average return* and *risk*. In short, performance compares average return to risk exposure. The most common performance measures are the Sharpe ratio and Jensen’s alpha (Aftalion and Poncet, 2003).

The Sharpe ratio measures the difference between the rate of return of the fund (Rf) and the risk-free rate (Tsr) or excess return divided by the volatility of the fund (Vf) in terms of standard deviations[14]. The higher the ratio the better the performance.

A key concept in active management, Jensen’s alpha or ratio is a relative measure of value-added or the manager’s talent. It measures the difference between the excess return on the fund (Rf – Tsr) and the excess return on the market portfolio or index (Rp - Tsr) multiplied by the fund’s beta (sensitivity) compared to that portfolio or index[15]. A positive alpha indicates relative outperformance, while a negative alpha means underperformance. There are several types of alpha, all of which use different methods to calculate performance (Grandin, 1998; Aftalion and Poncet, 2003).

Since it is possible to measure performance through several other indicators (information ratio, efficiency ratio, the Treynor ratio and the measures developed by Graham and Harvey, etc), it is often understandably difficult to present them in a coherent, relevant and precise manner. In order to prevent this problem, the AFG set up a monitoring group, the *Observatoire de la présentation des performances et des classements des OPCVM*, in January 1999 to oversee compliance with a code of practice designed to this effect. This code, which is approved by the regulator and aimed at both management companies and rating agencies and media organisations as well as providing guidance on methodological and corporate governance issues states, *inter alia*, that "a disclaimer must accompany the presentation of past performances stating that past performance does not predict the future results of the fund or its administrator". At present, most European countries conform to a local version of GIPS (Global Investment Performance Standards) in terms of performance comparisons.

Portfolio diversification *or the last "free lunch"*

Based on the old adage "don't put all your eggs in one basket", diversification appears to be a simple and natural "remedy" against the concentration of risk. It is one of the key activities of the industry. While the benefits of diversification are indisputable, determining the optimal number of securities or funds to include in a portfolio remains a complex problem, particularly where multi-management is concerned and doubly so in the case of alternative multi-management. (Lhabitant, 2004).

Portfolio management companies *or the lynchpin of investment management*

Institutions that undertake the financial, administrative and accounting management of investment products on behalf of third-parties: UCITS and discretionary mandates. Approved for this purpose by the AMF, they undertake to manage the sums assigned to them independently and in the sole interest of the investor (see diagram in the appendix). Whatever form delegation takes, liability rests, in law, upon the notion of the management mandate. Through the management mandate, the manager is given responsibility for investment decisions, i.e. buying or selling securities on behalf of the investor or principal within the framework of the investment policy defined in the contract. Apart from the traditional obligations to act with due diligence and report on the management of the portfolio to the principal, the portfolio management mandate generates two main obligations:
- an obligation of loyalty towards the portfolio holder. The administrator (and his managers), whose role is essentially fiduciary, must act solely in the interest of the portfolio holder. He is bound by this duty of loyalty under portfolio management regulations and the compliance rules set out by the industry in various texts. From this point of view, the fact that *investment management* is a recognised industry and that this function is separated from that of *depositary* and activities likely to give rise to conflicts of interest, such as *investment banking*, market activities and discretionary management, constitutes an *ex ante* mechanism of investor protection;
- an obligation of means: the administrator must have appropriate financial means (shareholders' equity, etc), the technical means (accounting structure, analytical decision-making aids, performance monitoring tools, etc) and the human means (an appropriate match between staff and the nature and development of activities) for the investment services on offer. This obligation is subject to separate approval by the regulator (AMF), which regularly audits and reviews the match between resources

and activity. In the case of alternative management, practitioners must provide a detailed work programme. Penalties including revocation of licences are possible if these commitments are not met.

Pricing *or the pathway from the portfolio to net asset value*

Pricing involves calculating the value of a portfolio of securities and other assets held by a UCITS or *discretionary management mandate* line by line minus debt by reference to current market prices (*market to market*[16]). This gives the net asset value or quite simply the net asset of a portfolio. As well as traditional *asset classes* (equities, bonds, cash, etc), funds also buy derivative contracts, i.e. *futures* and *options,* either as a substitute for securities, or in order to achieve a particular investment profile. This is what is meant by hedging or leveraging net assets, which may also invest in the units of other funds, particularly in a *multi-management* framework. Increasingly, the pricing function is being outsourced to specialists known as valuers, who record transactions and calculate net asset value, in addition to checking and publishing these net asset values. The net asset value (NAV) of a UCITS unit is obtained by dividing net assets by the number of unit trust units or investment trust shares. In the case of publicly sold funds, up-to-date net asset values are readily available, since they must be published and displayed in due form in the premises of the retail establishment as well as in the economic and financial press. In practice, most NAVs are calculated daily or less often (generally weekly). Since pricing requires substantial IT infrastructure investment, this function is being increasingly outsourced and the industry is in the midst of a period of consolidation.

Product range *or how competition drives innovation*

In recent years, a number of new products have emerged from efforts to adapt product ranges as closely as possible to investor demand and an increasing desire to rationalise those products. For example, it has recently become possible to market contractual funds (fund that may opt out of investment and risk diversification rules and which works in a similar way to a discretionary management mandate but still has the attributes of a *UCITS* in terms of *depositary* control, periodic *valuation*, statutory auditor, etc). Other new products include leveraged or non-leveraged simplified funds (ARIA and ARIA EL, see *UCITS*). These new types of funds are, among other things, finally laying the foundations for the development of alternative management in France: today through funds of funds and tomorrow perhaps through direct alternative management.

The master-feeder funds created in France in 1998 - while non-coordinated, i.e. they do not have a “European passport”, so cannot be exported - facilitate economies of scale in the management process. In this type of structure, one or more “feeder” funds, with a totally independent legal structure, invest their entire assets in another fund (the “master” fund). Feeders may not invest in assets other than the units or shares of the “master” portfolio.

New index funds are also being created in the form of *Exchange Traded Funds* (ETF), which have been trading at known prices thanks to continuous pricing on the Paris Stock Exchange since early 2001.

Socially responsible funds are also gaining a foothold: they invest their assets in the stocks of companies selected using a non-financial approach (on top of conventional financial analysis) based on a checklist of social, ecological or sustainable development criteria. They represent an additional investment route that may add strength to long-term active management.

Last but not least, the equity crisis has been driving forward demand for formula funds. This type of fund, which makes heavy use of *derivatives* offers investors performance that is based on a predetermined formula (for example a percentage of the performance of a stock-market index, etc) as well as guaranteed repayment of all or part of the initial investment (excluding front-end charges and management fees) as long as period conditions are met. This helps to explain the relatively small size of these and guaranteed funds, which both have a limited investment period.

Rating *or how management performance is assessed*

The purpose of a UCITS rating[17] is to quantify the consistency of a fund's performance and the quality of its management. The rating agency may also perform a qualitative analysis in which it evaluates the investment process, the structure of the management company and so on. The rating may also relate to the management company itself. In this case, the aim is to provide an independent and professional assessment of the company's capacity to meet the requirements of investors, particularly institutional investors, in terms of delegated asset management. It is based on various criteria, including examination of structure and resources, the degree of independence from the parent company, the suitability of the investment process, etc. Ratings, which are usually given for 12 months, may be revised if a major event occurs within the management company or in the life of the product (e.g. a change of manager). In 2002, four French trade unions (CGT, CFDT, CGC and CFTC) set up a certification system for company savings products that focus on securities from companies rated socially responsible[18] (see Chanu in this edition of the REF).

Rebalancing *or choosing a core discipline*

Rebalancing involves the regular adjustment of the portfolio composition in order to achieve constant, or almost constant weighting. It involves a basic management strategy known as *constant mix*, which contrasts with a *buy and hold* strategy where once the stocks have been bought, the manager waits for the fund to mature and then sells everything. In the first strategy, the manager regularly sells (or rebalances) the assets that have shown the best performance in order to buy those that have done less well. In the second strategy, in which the manager is basically passive, the proportion of high-performing assets tends to increase the longer the investment horizon.

Risk *or the raw material of management*

A fund's risk refers to uncertainty about future performance and includes both upside and downside uncertainty. Therefore, despite the common view, risk is not fundamentally negative. Intuitively, if the composition of a fund is stable, then past risk may be a useful guide to future risk. Fund risk arises from the variability of assets and changes in the composition of the portfolio. The most common risk measures include volatility, *Value at Risk* or VaR, sensitivity in the case of a fixed-income fund and beta for equity funds.

The intuitive meaning of volatility – the basic approach to risk measurement – is the upward or downward variability of a price. From a strictly statistical point of view, volatility measures the standard deviations (usually annualised) of past variations against an average. For example, a share price has an average historic volatility of around 20%. It is important to note that the volatility of a fund is lower than the weighted average of its assets, mainly because the returns on the various assets are imperfectly correlated. Implied volatility (a concept based on the Black-Scholes model) takes into account market expectations concerning various volatility factors included in the model. *Value at Risk* (VaR) measures the risk of loss at a given level of probability. Its purpose is to quantify, at a pre-specified confidence level (typically 95% or 99%), the maximum potential loss that a given portfolio or fund may suffer over a short period of time under “normal” market conditions and assuming that the portfolio is not altered in the meantime. Debt securities’ exposure to interest rate variations is measured by sensitivity or elasticity. In the case of a bond, for example, a sensitivity of 2 means that its price will increase (decrease) by 2% if interest rates decrease (increase) by 1%. The beta ratio, which comes straight out of Markowitz’s CAPM model, calculates the market’s contribution to the performance of a share or basket of shares. A beta of less than (more than) 1 indicates lower (higher) sensitivity to the index. Beta therefore measures the portfolio’s sensitivity to “its” market. If the manager expects the market to rise (fall), he increases (decreases) beta, so that the fund gains (loses) more than the market (Grandin, 1998; Aftalion and Poncet, 2003).

Finally, a relatively new concept – the risk budget – refers to the maximum total risk that institutional investors allow managers to take per entity or product. For example, the French pension reserve fund (FRR), which outsources asset management, allocates each of its managers a “risk budget” corresponding to an anticipated level of outperformance. The “spending” of the budget is regularly reviewed (de Salins, 2005).

Risk premium *or the reflection of investor risk aversion*

Over the long term, the risk premium represents the extra return demanded by investors for risky assets. Therefore, the risk premium of an investment equals the difference between the return of the investment (or portfolio) and the short-term interest rate (or risk-free rate). For example, if, at end-March 2005, the issue rate of a 10-year high-yield bond is around 7.5% and that of a 10-year euro zone government bond (rated AAA) is 3.68%, and the risk-free rate (Eonia) is 2.06%, the respective differences of 5.44% and 1.62% represent the risk premiums of these two bonds. Roughly speaking, the ratio between risk premium and volatility (Sharpe ratio) is around 0.3. Thus, if an equity portfolio has a volatility of 20%, its risk premium should be around 6%; for a bond, the figures would be 5% and 1.5% respectively. There are other premiums that are just as important as the risk premium such as the liquidity premium, the credit premium and the inflation premium.

Spread *or margin-seeking on large volumes*

A key concept in fixed-income management, *spread* represents the difference between a bond’s yield and a benchmark rate. *Spread* is generally measured in basis points on like maturities and coupons. The difference or *spread* is representative of the default risk and liquidity risk of a debt security. By extension, *spread* may refer to the yield differential between two maturities (curve *spread*) or between two markets such as the euro and the dollar (intermarket *spread*). The *spread* between fixed and real rates (the yield on inflation-linked bonds) is called “break-even inflation”.

Stock-picking (management approaches) *or the social utility of financial analysis*

Stock-picking is a method – or culture – of individual stock selection, which is not confined to shares, whereby managers try to identify attractive stocks, generally after in-depth financial analysis. At least two groups of apparently opposing “pairs” of management approaches are possible based on different stock-picking methods.

In the first group, two approaches may be applied:

- the *bottom-up* method, in which the manager selects stocks on the basis of financial analysis that allows him to identify growth opportunities;
- the *top-down* method, based first on a macroeconomic analysis of various geographic regions, then various branches of industry followed by a stock-by-stock analysis. In this approach, country and

sector allocation precedes individual stock selection.
In reality, the portfolio is often created from an ad-hoc mixture of information from these two approaches.
The second group also contains two approaches – quantitative and traditional:
- as its name suggests, quantitative management relies on quantitative, often mathematical models based essentially on databases;
- whereas traditional management relies on company knowledge and a mixture of quantitative and somewhat qualitative data arising from fundamental analysis of information pertaining to the company or its environment that may influence future stock prices (Mathis, 2002).

UCITS *or a gateway to professional and diversified management*

UCITS (undertaking for collective investment in transferable securities) are designed for saving and investing in securities (equities, bonds, debt instruments, etc) according to pre-established criteria, which are presented in the prospectus (renamed the simplified prospectus in the wake of the OPCVM III Directive). This document summarises the features of the product and must be issued to all investors prior to subscription. The prospectus serves as an "id card" for the product, describing its main details such as the identity of the manager, the depositary and the sponsor, classifying potential risks, management approach, recommended period of investment, subscription and management fees and past performance, etc.

UCITS provide access to a portfolio of diversified securities managed by approved and regulated investment professionals. In order to provide security for savings, these products are subject to a tight legal and regulatory framework including risk diversification ratios, ongoing supervision of the administrator by the *depositary* and the regulator, statutory audits, periodic valuation and transparency of fees and charges, etc.

UCITS are divided into two categories according to the way they distribute income. Accumulator funds directly reinvest the income generated by the portfolio, while distributor funds pay a dividend to unit holders. Some funds offer a mixture of accumulator and distributor shares.

There are two legal forms of UCITS or OPCVM in France[19]: open end investment companies known as *SICAVs* (*Société d'investissement à capital variable*), which issue shares, have a legal personality and, consequently, may be self-managed (in reality they are almost always managed by management companies), and unit trusts known as *FCP* (*Fonds communs de placement*) which are unincorporated co-proprietorships of securities divided into units and managed by an intermediary (management company or ISP). FCPs can be divided into two categories: "general purpose" FCPs which are governed by UCITS directives, and usually have a "European passport" allowing them to be registered throughout the EU and "special purpose" FCPs such as company-based funds (FCPE), venture capital funds (FCPR), innovation funds (FCPI), local investment funds (FIP) and futures and options funds (FCIMT), etc which are regulated on a purely national basis (see table in appendix).

A new range of nationally regulated funds has existed in France since the beginning of 2005: leveraged funds (ARIA funds) and contractual funds. Because these funds are intended solely for "qualified investors" they cannot apply for public subscription (see product range).

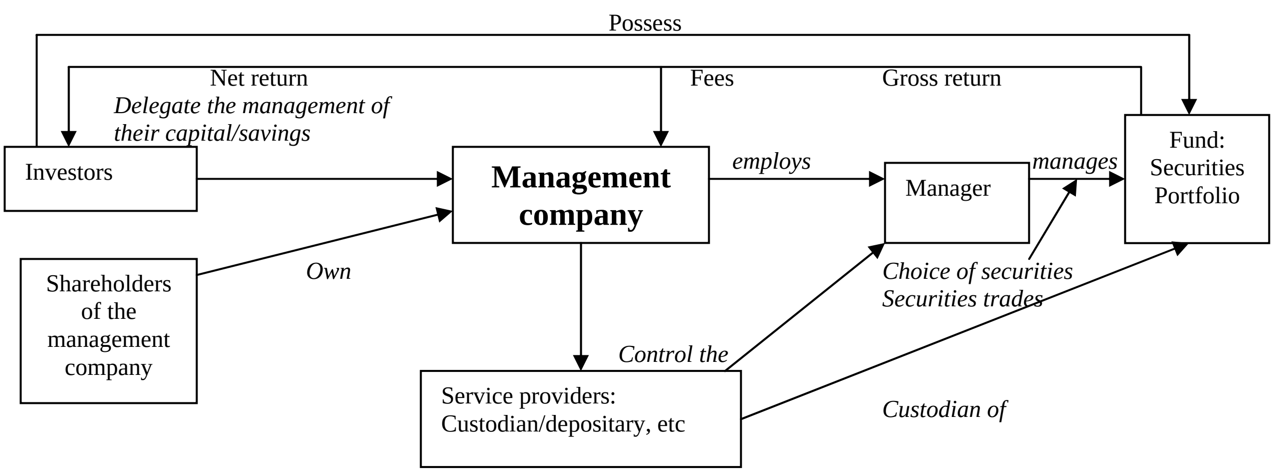
Appendix

Delegated management or services and products for individual customers and institutional investors

Individual discretionary management	Collective Management		
	UCITS		Other collective investment vehicles (“without passport”) [a]
	General purpose (“with passport”)[a]	Special purpose (“without passport”) [a]	
* Institutional or private management mandate	*SICAV * “General-purpose” FCP	*FCPE *FCPR incl. FCPI and FIP *FCIMT *Master-feeder funds Leveraged or non-leveraged ARIA funds[b] Contractual funds Multi-management (funds of funds, etc)	*SCPI *FCC *Other funds (commodities, etc)

a – “With passport”: funds conforming to European directives; “without passport”: funds governed by national regulations, i.e. non-exportable
b – Leveraged or non-leveraged simplified funds.
Source: AFG.

Investor safeguard mechanisms or the operational framework of a management company



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Key words (below in italics) relate to the thematic entries (in brackets)

NOTES

1. With a reduced down payment, thanks to a credit facility or options, the investor can adjust his exposure to market risk.

2. Combining the purchase of shares considered undervalued (long positions) and the short selling of shares judged overvalued within the same portfolio. The portfolio is usually built from the bottom up. Made up of general or specialised funds, *emerging markets*, *dedicated short bias*, *equity market neutral*, they represent 35% of "alternatively" managed assets.

3. Event-driven strategies focus on stocks issued by companies experiencing particular circumstances, such as a merger, acquisition, takeover bid or exchange offer, restructuring or, worse, a state of financial distress (they represent 33% of the alternative universe). The prices of these stocks often behaviour in an atypical manner, which is precisely what attracts hedge funds.

4. Diverse set of relative value strategies (involving convertible bonds, interest rates, indices, etc) all seeking to capitalise on inefficiencies and market opportunities associated with price or rate dislocations between two closely interdependent assets. Generally speaking, they gamble on price convergence.

5. Two types of funds characterise this group: global macro and CTA (commodity trading advisors) or managed futures. They take directional positions in order to cash in on broad market trends. They are highly leveraged and have become much less common since the late 1990s.

6. For an in-depth insight into the asset allocation policy debate see Davanne in this issue of the REF.

7. The trader gathers, sorts and transmits market information relating to the securities chosen by the portfolio manager. He also monitors and executes orders and chooses the broker and the timing of trades. This function is sometimes delegated to external consultants.

8. Institutions, usually banks, with a sideline in investment management. They often specialise in *private banking*.

9. These codes are available on the AFG website: www.afg.asso.fr

10. Custody is being increasingly delegated to an authorised intermediary, who in addition to the "safekeeping" and administration of securities on behalf of customers provides various other services such as clearing and settlement and delivery. The custodian may exercise his activity on either a national market (*local custodian*) or offer services on an international scale (*global custodian*), in which case he relies on a network of local custodians.

11. In essence, the risk profile depends on the proportion of fixed-income products to equities. For example, a typical balanced profile contains approximately 50% shares or risky products and 50% fixed-income and/or cash products. By contrast, a conservative profile should contain few high-risk equities, e.g. a maximum of 20% shares and 80% fixed income products.

12. Investment management is often defined in opposition to discretionary management, in which the customer himself, whether an individual or an institution, compiles and manages the portfolio directly, placing orders etc himself.

13. Contract between the administrator and the "client", the mandate is made concrete by the signing of an indenture (or written agreement). In the case of collective management via UCITS, subscription has the effect of adherence to the management contract, evidenced by the prospectus or simplified prospectus.

14. Sharpe ratio = $(Rf - Tsr)/ Vf$

15. Jensen's alpha = $(Rf - Tsr) - \beta(Rp - Tsr)$

16. When an asset class is unlisted a pricing model is used.

17. The main rating and fund classification agencies include: Standard & Poor's, Morning Star, APT and Lipper. Fitch-AMR and RCP & Partners rate management companies.

18. In France and Europe, a number of specialist agencies (including Vigeo, Novethic, etc) currently rate stock issuers according to social and environment criteria.

19. In practice, there is no significant observable difference in the way these two types of entities operate, except that FCPs have more administrative flexibility than SICAVs.

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