Attached is an excerpt from a recent article published in <u>The *Economist*</u>: For the complete article, visit www.economist.com.

Pension committees and investors of all stripes need to embrace some of the lessons The *Economist* is exploring below. Often it seems investors won't perhaps because of a perverse trait of human nature, an inner voice that says when it comes to investing, doing the rational and simple is unappealing, it doesn't work. Offer a complex, risky and expensive investment "alternative" (say something from Amaranth Advisors LLC), investors will go for it with both feet and for good measure, may even borrow to get more. Human nature!

Fund management

Alpha betting

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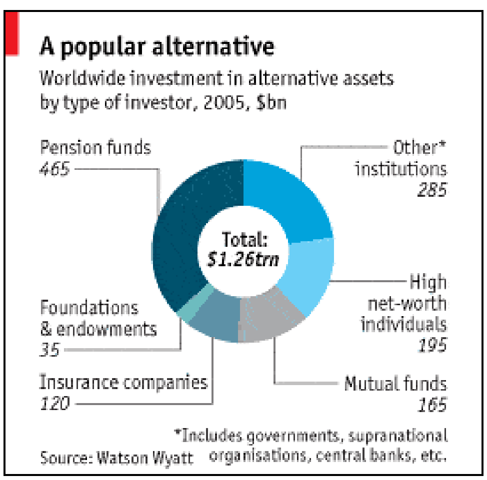
The industry is splitting in two—and investors are gambling on the expensive bit

IT HAS never been easier to pay less to invest. No fewer than 136 exchange-traded funds (ETFs) were launched in the first half of 2006, more than in the whole of 2005. For those who believe in efficient markets, this represents a triumph. ETFs are quoted securities that track a particular index, for a fee that is normally just a fraction of a percentage point. Morgan Stanley estimates that ETFs control some

$487 billion of assets, up 16.7% from a year ago. It predicts they will have $2 trillion of assets by 2011. But as fast as ETFs are growing, Watson Wyatt, a firm of actuaries, estimates that “alternative asset investment” (ranging from hedge funds through private equity to property) grew even faster by as much as 20% in 2005, to $1.26 trillion. Investors who take this route pay much higher fees in the hope of better performance. One of the fastest-growing assets, funds of hedge funds, exact some of the highest fees of all.

At first sight, this might seem like a typical market: if you buy the Rolls-Royce you can expect a higher standard of luxury and engineering. But fund management is not like that; paying more does not necessarily get you a better service. After fees, hedge-fund returns this year have actually been feeble. From January 1st through to August 31st, the average hedge fund returned just 4.2%, according to Merrill Lynch, less than the S&P 500 index's 5.8% total return.

So why are people paying up? In part, because investors now distinguish between the market return, dubbed beta, and managers' out-performance, known as alpha and as Arno Kitts of Henderson Global Investors, points out “Beta is [seen as] a commodity and alpha is [seen to be] about skill.”



The fund-management splits began with the decline of balanced managers, which took complete charge of an investor's portfolio, running everything from American equities through Japanese bonds to property. That led to the “core and satellite” model, in which part of the portfolio was invested in index trackers with the rest in the hands of specialists. This new approach created its own problems as it is much harder to monitor the performance of specialists and in turn encouraged the middlemen—managers of managers (in the traditional institutional business), funds-of-funds (in the hedge-fund world) [and many consultants to coordinate and navigate in this more complex world]. Middlemen are expensive. Managers of managers, such as Patrick Disney of SEI (Europe), say they can use their buying power to keep fees down but their fees still tend to be higher than the fees charge by a traditional balanced manager, let alone an ETF. That such fees endure might suggest investors can identify outperforming managers in advance. However, studies suggest this is extremely hard and as Nigel Williams of Barclays Global Investors, a big index tracker, notes, consistently outperforming the market is hugely difficult (NOTE: Shaunessy's observation is that it is virtually impossible by a specialist). And even when you can spot talent, much of the extra performance may be siphoned off into higher fees. "A disproportionate amount of the benefits of alpha goes to the manager, not the client," says Alan Brown at Schroders, an asset manager.

Yet investors are willing to gamble, despite the higher fees, because they desperately need high returns. Peter Harrison, chief executive of MPC, a fund manager, says that American pension funds have analyzed their liabilities. "They need beta returns to make up the shortfalls in their funds and they have to roll the dice and try to get it."

The same rationale led to the enthusiasm for other forms of alternative assets, such as property and commodities. These appeared to offer a different source of returns that was not closely correlated to shares or bonds. The problem is that, as more money piled in, the character of such assets changed reducing prospective returns and exotic assets are now correlated with run-of-the-mill ones. Nevertheless, investors keep pursuing alpha and as long as that desire exists, managers can charge high fees.