Swiss investors starting to reap benefits of logic rather than luck

End-investors are coming around to the view that 'hero fund managers' often generate excess returns through luck rather than expertise. This leaves them more willing to accept portfolios with stronger risk-return characteristics, says Pius Zgraggen of OLZ.

The days of the 'hero fund manager' are numbered and set to be replaced by an era of more efficient investing, believes Pius Zgraggen, founding partner of Berne-based OLZ & Partners Asset & Liability Management.

His firm, founded in 2001, aims to take advantage of this development by creating portfolios that de-emphasise stock picking and market timing to focus on risk-adjusted returns.

"We believe that in the future a growing number of these heroes will be demystified," Zgraggen explains. "In the 1980s if you were a fund manager and beat the market you became a hero, but in recent years alpha (outperformance) has been explained by other, systematic factors than just the market factor.

"Part of it is size, part of it is value, part of it is momentum, and part of it is low volatility – so in the end you find there actually is much less real 'alpha' [being generated by the fund manager]."

OLZ's formula, and indeed the firm itself, were founded on the belief that return can't be projected but risk is more persistent. As Robert Merton found out years ago, the best estimate of the expected performance of any market or stock is to start by giving all shares the same expected return.

"Despite this, 99% of active fund managers say they are able to forecast returns and identify undervaluation or overvaluation. We did not believe this from the outset because we had no empirical or theoretical evidence," Zgraggen says.

After years of academic research at the University of Bern, this belief prompted the founding partners to set up OLZ as a specialist in minimum variance portfolios. The name 'OLZ'

PIUS ZGRAGGEN
OLZ

stands for the three founders: 'O' for Carmine Orlacchio, 'L' for Claudio Loderer and 'Z' for Zgraggen. Loderer is managing director of the Swiss

Finance Institute (SFI), founder of the Rochester-Bern Executive Program, and a full professor of Financial Management at the University of Bern, where Zgraggen was a research and teaching assistant and Orlacchio a research assistant.

Zgraggen believes the main benefit of minimum variance investment over passive (such as traditional ETFs) and active management is lower volatility that allows greater exposure to equity without taking on unnecessary risks. “Instead of having 40% invested in an equity index you can have about 50% invested for the same amount of risk. Besides this, investors gain a higher return over the long term,” he adds.

Headquartered in Bern, OLZ also operates out of Zurich and Schaan (Lichtenstein). It established a presence in Singapore in 2007 with subsidiary OLZ Wealth Management.

INVESTMENT PHILOSOPHY

For qualified investors the firm mainly offers Swiss franc-denominated equity and bond funds, with some euro and US dollar classes.

Two of its funds have been registered in Singapore since 2010. The first, OLZ Efficient World Equity, invests in developed equity markets. It is based on OLZ’s core proposition – using minimum variance to optimise risk-returns versus market-cap weighted investment schemes. The second fund adopts the same approach to emerging markets and aims to generate better risk-adjusted returns than the MSCI Emerging Market index.

In addition to its funds, OLZ has a wealth management proposition that includes financial and liquidity planning, risk and cost analysis, asset and liability strategies, and reporting and benchmarking. It also provides financial institutions with data that enables them to implement their own minimum variance portfolios.

Although Zgraggen might decry the ‘hero fund manager’ concept, he and OLZ have reputations for being at the vanguard of investment theory.

Zgraggen is well-known in academic circles, having co-authored *Handbuch der Bewertung* (*A Handbook of Valuation*). He is also a lecturer at PHW (Private Economics University) in Bern, the University of Liechtenstein, and AZEK (the Swiss Training Centre for Investment Professionals).

“The huge advantage of minimum variance is that instead of having 40% invested in an equity index you can have 50% invested for the same amount of risk.”

PERFORMANCE REVIEW

Teaching the difference between the concepts of speculating and investing is one of his main objectives. “In most cases people mix the two,” Zgraggen explains. “But we say we cannot speculate for our clients, they have to do that on their own by opening an account and trading. Our objective is to manage the other part of their investment portfolio, which they want to grow, or build towards a purpose.”

Once the target is established, OLZ creates a model portfolio and calculates how this would have performed had it been in place for 20 years, so the client has a clear view of the investment risks.

“We then go to into detail on how much they might lose, and if they are willing to accept that it will be cheaper for them to give us a mandate than follow the strategy on their own,” Zgraggen adds.

OLZ agrees a management fee with clients, and then credits them the fees OLZ collects out of its own funds, any third-party distribution fee, and retrocessions received from the custodian bank. This means clients not only don’t pay double or even three times the normal fees, but also gain an independent investment strategy.

This matches the direction of the global fund and wealth management industries, but Zgraggen is only cautiously optimistic. He suggests investors deserve absolute clarity not only on how much they are being charged but what they are being charged for.

“You can now be paying a fee to fund managers who give the impression that they know where and when to invest,” he explains.

“Mandate and advisory fees have to go up because there are no longer retrocessions. This is a good thing if charges are transparent. But the incentive system of the advisers has not changed, they still have to make a return on assets, so the clients are getting charged the same only in a different way."

He is absolutely clear about OLZ's own value proposition.

"Our value proposition is that we focus on risk forecasts to emphasise diversification and how you do this efficiently," Zgraggen says. "At the end of the day, if you want asset allocation, you can go to a consultant, and there is also a huge trend of implementing this via capital weighted indices (ETFs).

"If you do so, you are invested like an average investor but not like an efficient one".

This is not a trend that OLZ is interested in following.

"If you buy the index the marginal cost is zero," he adds. "We do not want to step into this area as we cannot compete at marginal cost where everything is determined by volume."

"If you buy the index the marginal cost is zero ... We do not want to step into this area as we cannot compete at marginal cost where everything is determined by volume."

GROWTH OUTLOOK

Adding volume is not without benefits, however, as Zgraggen acknowledges OLZ's recent growth can be seen as testament to the efficacy and appeal of its investment philosophy. "Our funds have grown and are becoming more attractive to old and new clients," Zgraggen explains.

"One insurance company could only hold 20% in one of our funds when it was, say US$100 million, but now that fund is more than double in size it has doubled the investment."

Earlier in the year OLZ's Swiss Equity and Developed Market Equity received combined inflows of CHF300 million (US$321 million), he notes, adding that its next target is Switzerland's private pensions market: "This is very big in Switzerland, where you can privately save almost CHF7,000 a year and it is tax deductible.

"At the moment most of this is invested with banks fund solution but we aim to enter the market."

On the product front, Swiss pension funds mostly invest separately in domestic and international equities, so OLZ has developed a global equity ex-Switzerland portfolio.

More generally, OLZ plans to add a European equity minimum variance portfolio to its range in August 2015.

Technology has been a vital facilitator of such investment strategies, and OLZ's successes, Zgraggen says.

"Technology means we can now take the MSCI World index, extract the country data, create an investment universe and then check that this has sufficient liquidity," he explains.

"We can then estimate the risk and co-variances to create the minimum variance portfolio, which was not possible before as we had neither the data nor the technology."

Zgraggen acknowledges OLZ's approach of focusing on risk rather than return can be a hard sell to investors.

"People normally don't give a strategy enough time, yet if they invest at the right time it is purely by accident.

"You need to give a strategy 10 years, but you shouldn't look to change funds just because you invest in the wrong three years."

Technology has been something of a doubled-edged sword in this respect.

It has increased the regularity with which clients look at their portfolios, encouraging short-termism, according to Zgraggen.

"People have a look every week, but if you have weekly reporting, even if the strategy is fabulous, you will be disappointed 23 or 25 times a year," he concludes.

"One of the difficulties we are facing today is how to explain to the client at the outset what a strategy means, how it works, and how long it will take to work." ■