

# The Zurich Report

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## Mirroring benchmarks – are we doomed to make these mistakes again?

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### Summary

We would not ask people to drive their cars down the road looking in the rear vision mirror, would we? And yet, this is exactly what more and more international share fund managers appear to recommend as their performance and holdings mimic those of global benchmark indices, which reflect accurately where stock prices have been, but not where they are going.

Twenty years ago, a team of global fund managers reached the conclusion that whilst the world was changing, investment management techniques were not.

Globalisation had arrived, but investment analysis had not adapted to it. As a result, the team introduced a thematic approach to investment. This approach involved the identification of major trends or themes in the global economy and investing in the stocks most likely to benefit from them.

### Looking back at benchmarks

Benchmark share indices around the world have become more important in recent decades as increasingly competitive fund managers have sought measures against which to provide superior performance. This became a feature of institutional and, increasingly, retail funds management markets. Whilst it was, and remains, a reasonable means of comparing the ability of fund managers to add value to client portfolios over and above baskets of

representative shares, the trouble sets in when these benchmarks start to define the investment universe or are used as a guide for portfolio construction.

This was clearly in evidence in the late 1990s as the tech bubble reached dizzying heights. In Australia, the upward surge in the value of News Corp shares in 2000 caused consternation for fund managers in Australia. For those fund managers who did not hold News Corp, its sudden surge – and the dramatic contribution it made to benchmark performance – alerted them to the relative performance risk of straying too far from the benchmark as clients increasingly focused on short-term relative returns.

Moreover, the generalised tech boom had seen fund managers struggling to keep up with the performance of global indices, which they began rushing to match. The technology, telecommunications and media sector of the Morgan Stanley Capital International ("MSCI") World Index swelled to represent 34% of the index by March 2000. Ironically, this bubble had emerged despite a generalised decline in earnings in the last half of the 1990s and regardless of the fact that many of the emerging technology companies had produced little or no profits.

For many fund managers, who started employing benchmark-aware 'hard limits' on their funds, they found their weightings in these sectors were rising just as they were reaching their most extreme levels of over-valuation!

It is a similar story when it comes to countries. During the go-go years of the late 1980s, Japanese shares rose to make up 43% of the MSCI, larger even than the representation of US companies despite its economy never approaching anything like the size of the US. Yet, benchmark-aware investors soon discovered this was clearly the worst time to allocate 43% of your global equities to Japan as the

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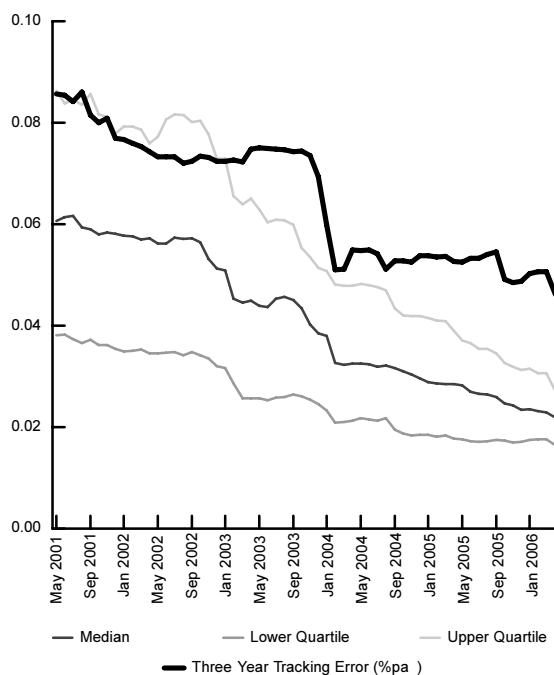


Nikkei plunged from 38,915 to 7,608, a fall of over 80%, over the next 14 years.

In these circumstances, far from the MSCI World Index providing a reasonable yardstick for portfolio construction, just like the tech boom it actually captured the bubble that had emerged, in this case Japanese share prospects.

Despite these lessons, Figure 1 shows that the tracking error of international fund managers, or the difference in their performance from the benchmark, has actually been falling in recent years.

**Fig. 1. Proof of the growing index mentality – narrowing tracking error.**



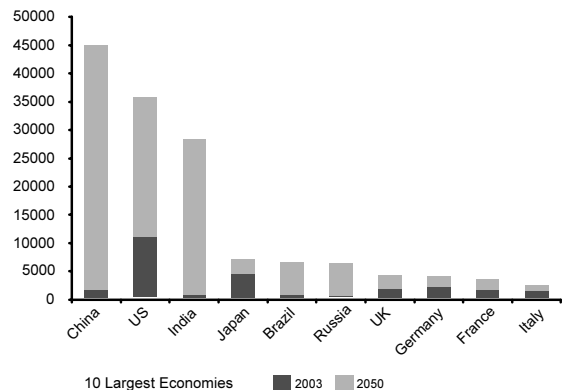
Median – Tracking Error in Overseas Shares from April 2001 to March 2006. Median versus MSCI (before tax and before fees)  
Source: Mercer MPA

## Looking forward

Are we doomed to make these mistakes again?

If the shape of the MSCI today is any guide, it would seem so. The economies of China and India are beginning to reshape our lives, as reflected in booming commodity prices, ubiquitous Chinese-made goods and growing telemarketing calls from the subcontinent. According to research from Goldman Sachs shown in Figure 2, China is set to overtake the US as the world's largest economy in 2035, less than three decades from now, with India in hot pursuit.

**Fig. 2. What will the world look like in 2050? 10 Largest Economies**



Source: Goldman Sachs Global Economic Paper 99, 2003.

The US economy, though large, currently makes up slightly less than 30% of the global economy and is shrinking. Why then, a global investor might ask, would I want to start today with an allocation of 50% to US shares? Because that is what they currently make up in the MSCI, and what would be allocated with a benchmark-aware approach to investing.

At the same time, global investors have to grapple with such concerns as rising levels of geopolitical risk, the ageing of first world populations and shortages in fossil fuels. How do investors synthesise these competing trends into a long-term investment strategy using benchmark indices?

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## Thematic investing

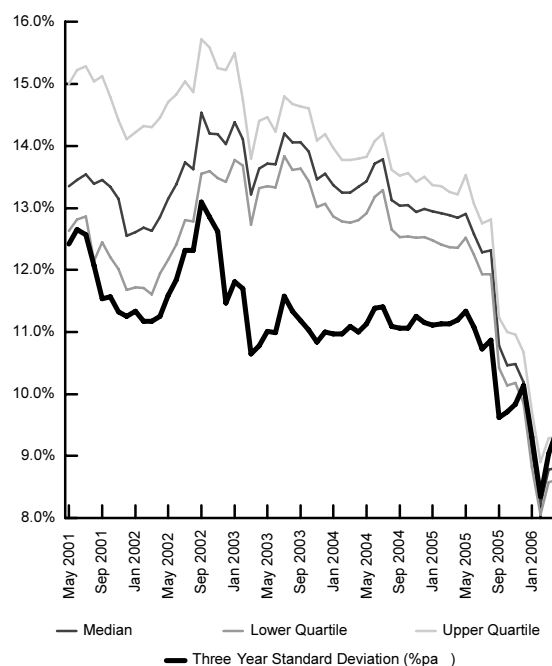
These were precisely the sort of concerns that the team responsible for the Zurich Investments International Share Fund were seeking to satisfy when they initiated their thematic investment approach in 1986.

The investment discipline they developed sought to identify the major trends developing in the global economy, whether secular, structural or cyclical, and form investment themes around the ones that offered upside investment opportunities. They would then search the world for companies, which were most likely to benefit from these trends. The benchmark allocations of countries or sectors play no part in the investment process. The stocks selected can be from any country or sector as long as they fit the thematic criteria the team is seeking to exploit.

Recognising the absurdity of country diversification when Japan was 43% of the MSCI in 1989, or the US 50% in 2006, the team's decision to diversify instead comes from the differing nature of the investment trends themselves, which have ranged from oil shortages and gold exposure amid geopolitical risk to hidden property wealth in German and Japanese companies and 'virtual' businesses, which have outsourced all but their highest value-added intellectual capital.

By having around 10 themes at any point in time, the process also ensures that our thematic fund does not become overexposed to any single investment trend, such as the tech bubble of the 1990s. Because of the differing nature of the investment themes, they have a low correlation with each other. This a deliberate outcome of what the thematic approach aims to achieve. Therefore, when blended together, the themes deliver a low overall level of volatility in returns, as demonstrated in Figures 3 and 4. The process delivers consistently lower levels of volatility over time relative to other international share managers.

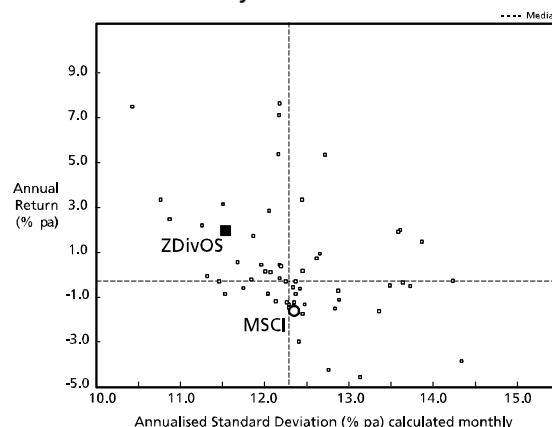
**Fig. 3. Lower absolute risk – rolling 3-year standard deviation versus peers.**



Zurich International Equities Series 1 – Standard Deviation in Overseas Shares from April 2001 to March 2006. ZIEF (before tax and before fees).

Source: William M Mercer (31 March 2006)

**Fig. 4. Outcomes...performance and volatility – risk/return 5 years to 31 March 2006.**



Zurich Diversified Overseas Shares – Comparison with the Mercer Overseas Shares Universe. Annualised Risk and Return for 5 years ended March 2006 before tax and before fees.

Source: William M Mercer (31 March 2006)

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## Conclusion

For investors seeking exposure to the best investment opportunities in the future, the MSCI World remains a poor guide.

But, in the absence of country and sector weightings, how do investors get broad exposure to the best future opportunities?

The thematic approach searches out the most attractive global investment opportunities – whatever their industry or location.

The thematic investment team examines major changes taking place around the world – structural economic, social, demographic or political – to identify themes that represent a distinct investment opportunity. All themes are methodically researched and tested in order to establish their validity. At any one time, the portfolio can include 8-12 themes that are deliberately very different to one another to give the portfolio broad exposure, and stocks are aligned with themes, not country/industry weightings of the MSCI Index. This results in holdings significantly different to the MSCI.

This benchmark-unaware approach has delivered strong long-term returns to such funds as the Zurich Investments International Share Fund, which have been significantly less volatile than the MSCI and many comparable international equity funds.

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