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CASE STUDIES

"Case Studies" presents a case pertinent to contemporary issues and events in investment management. Insightful and provocative questions are posed at the end of each case to challenge the reader. Each case is an invitation to the critical thinking and pragmatic problem solving that are so fundamental to the practice of investment management.

Jack L. Treynor, Senior Editor

FIDUCIARY FUNDS

Oscar Johnson was a portfolio manager with Fiduciary Funds, a mutual fund complex. He was pleased when his employer asked him to develop a type of mutual fund that would be new for them. The complex had an investment philosophy that emphasized bargain hunting rather than betting on new investment insights. What his bosses wanted was a global fund, new to them, that would include both

(1) an actively managed piece that would be consistent with their investment philosophy, and
(2) a passively managed piece that provided a high degree of diversification.

To help organize his ideas, Johnson had drawn up two lists of potential industries:

(1) Industries whose market was basically local, whose prosperity was presumably tied to the host country's prosperity. He called these industries "home goods" industries.
(2) Industries whose market was global. He called these industries "tradable goods" industries.

Johnson did not want to rule out any industries that were big and mature enough to have well-developed securities markets. On the other hand, he had several questions he was anxious to resolve:

(1) For companies in the same home goods industry, but different countries: if the countries were at different stages of the business cycle, would he encounter timing problems in making value comparisons?
(2) Would tradables industries, with their global markets, pose any diversification problems?
(3) Some of his shareholders would be nervous about currency risk. Should he hedge
    (a) All the non-US positions?
    (b) All the non-US home goods positions?
    (c) All the non-US tradables funds positions?
    (d) None of his positions?

Johnson would be meeting with his bosses next week. He knew they would be curious about his preliminary thinking.

DISCUSSION

A global fund opens up new opportunities for diversification, for investment comparisons, for bets on currencies. Oscar has a lot to think about.

Active bets

Bargain hunting is a species of active management in which decisions to buy and sell are based on analysis of a company's investment value. As Sidney Cottle pointed out, such analysis entails *comparison*. If Johnson is going to base the active positions in his global fund on comparisons he should use a single valuation model, rather than different models for different countries. But the valuation model should allow for the differences between home goods industries and tradables industries. The former depend on local economic prospects, the latter on global economic prospects.

Home goods plant vs. tradables plant

The value of home goods plant, for example, will be driven by local developments in

currency value,
central bank policy,
inflation,
fiscal policy, and
political climate.

On the other hand, the price of a tradable product will be determined globally—i.e., by reconciling global supply with global demand. And its manufacturing cost in the different countries should be easy to compare, with one important caveat: different countries have different real wages. A convenient measure of the difference is the "real exchange rate"—the "nominal," or conventional, exchange rate, adjusted for the two countries' money wages.

Brand franchise

Brand franchise is an important source of value, and risk. Not all tradables industries are commodity industries—industries where brand is relatively unimportant. Franchise is intrinsically local, in the sense that its value depends on the prosperity of the country where the franchise is located, rather than where the company's manufacturing plant or headquarters is located. But if the life of franchise is an order-of-magnitude shorter than the life of plant, then their relevant economic prospects may be different even when they are located in the same country.

Hedging

When the value of the local currency changes, the dollar value of its (tradable) raw materials and tradable products do not change. Only the labor costs of a foreign *tradables* company change. Currency hedging the investment in such a company can consequently increase, rather than reduce, the exchange risk. And because of interactions with inflation, interest rates, etc., currency change can have complicated consequences for the local demand for foreign home goods.

Reductions in currency value consequently affect different companies differently—reducing the real wage for tradables manufacturers, and raising the inflation rate, hence dimming local prospects, for home goods plant and franchise. On the other hand, big international companies with assets in lots of foreign countries will be less dependent on particular currencies.

Accumulating inflation will affect the money wage element in the real exchange rate. But the nominal exchange rate is obviously the principal source of sudden changes. Exchange rates and currency values are relative, not absolute, numbers. Do such changes merely *redistribute* the value of tradables plant between countries? Is a global portfolio of tradables plant, which depends on the prospects for global demand, less diversified than a global portfolio of home goods plant, which depends on the prospects for many individual countries?

Oscar's options

Clearly one way to address the need for both core and active segments is to use home goods companies for a highly diversified passive core, where investment comparison would not be necessary, and to use tradables companies, which were hard to diversify and easy to compare, for the active segment.

But whatever basic architecture he chooses for the portfolio, Oscar will need expertise on

currencies,
countries,
industry sectors, and
companies and their management.

Is he going to need subadvisors to complement his own employer's special research strengths? Conceivably, he could divide the responsibilities in various ways:

active—passive,
home goods—tradables,
plant value—franchise value,
local—foreign.

Oscar can probably expect to have both active and passive holdings in many of the same countries. Will the client understand what Oscar is doing? Are there different kinds of global equity fund? Will the client understand the differences? And who is Oscar's intended client? How should he market the fund to this client? And the client will probably want him to measure his tracking error. But relative to what? Who is his real competition?

Oscar may want to ask his secretary to hold incoming phone calls while he considers his options.

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