

the SQUEEZE is ON

BY PETER GALUSZKA

**When investors
give greater weight
to alpha concerns,
beta managers
feel the pressure**

The fable of the tortoise and the hare — slow and steady versus fast but streaky — may be simplistic, but it does illustrate points about where investors and investment managers are placing a lot of attention these days. Today's market conditions are such that both equities and bonds are bringing in only single-digit, rather than double-digit, returns, which means that managers who can tease out those extra, precious percentage points of return are at a premium. In the near term, the demand for such alpha managers will only increase.

So, how has the new focus on alpha affected beta? It's a good question that can't be easily answered, portfolio managers say. Managers whose strategies deliver beta returns likely will have to work harder and faster to please institutional investors and keep their jobs. Money managers in general will be under more pressure than ever to produce above-market returns.

A Lack of Respect

Why doesn't beta get any respect? After all, when you brush aside a lot of the hype, beta is and will remain the solid bedrock upon which much of the credibility of investing is built. "People have focused too much on alpha and not on beta. Maybe they should focus on getting the beta manage-



ment correct," says Arun Muralidhar, chairman of Plano, Texas-based Mcube Investment.

Indeed, investors might want to take a deep breath and not get too excited about alpha. "Smoke and mirrors is probably too strong a word for it," says John Loftus, a managing director at PIMCO in Newport Beach, Calif. "I've seen more PowerPoint presentations about alpha as the 'Brave New World' where anything can be done. Bologna."

One of the basic challenges in understanding alpha and how it affects beta is getting definitions right. The concepts have been around for more than 40 years. Loosely defined, beta is the relative volatility of a security compared with its asset class while alpha is the excess return derived from active management.

According to Loftus of PIMCO, during the 1980s and 1990s, neither term was defined very clearly. "There was a lot of misuse of the term and only recently have people been disciplined enough (since the 2000 stock market crash) to apply it correctly," says Loftus.

Nor did it seem to matter because the stock market was so strong during most of those years that simple beta management brought handsome returns. Alpha was regarded as something academics toyed with. If the market was bringing in double-digit returns, the thinking went, why bother setting up a lot of bells and whistles to earn an extra, say, 200 basis points?

And while many experts say alpha and beta should be separated so what each delivers can be clearly seen, how does

one precisely define alpha and beta? "Chances are," says Phil Green, managing director and senior portfolio manager of Merrill Lynch Investment Managers in Plainsboro, N.J., "if you have a manager who goes back to two academics and says, 'Tell me how much return is due to alpha and beta,' those two academics will come back with two different answers. That's not because they are looking at different data but because they have different definitions of what beta is."

Defining Beta

For many years, beta was defined as a measure of the degree to which a stock price changes in relation to a market or index. A stock with a beta of less than 1 was considered relatively less risky while a beta of 3 meant that a stock would be three times as volatile as the market.

Nobel laureate William Sharpe is credited with devising the beta concept in his 1964 paper on the capital asset pricing model (CAPM). A decade ago, academics Eugene Fama and Ken French tried to zero-in more precisely on what beta really means. They studied stock returns from 1926 to 1997 and concluded that a "three factor" approach was key, consisting of how much stock market exposure investors are willing to accept, how large the companies are that they want to buy, and the book value to market value ratio of their stock buys.

Fama and French's findings capped a mounting body of evidence that cast doubt on the value of active management. Once fees and costs were extracted, a majority of active managers couldn't consistently beat the S&P 500. As a result, some reasoned that investors might be better off looking for passive managers who didn't cost as much.

All of the attention focused on today's alpha managers begs important questions. If most of yesterday's active managers couldn't beat the market consistently, why should investors expect today's alpha managers to do any better? Won't passive beta management do better than half of alpha managers?

Analysts such as Muralidhar and Loftus say that there's no doubt that competent beta management will continue to produce decent returns. There are changes, however, that have given active or alpha managers an important edge, according to Charles Ellis, CFA, managing director of Partners of 63, an investment house based in New Haven, Conn. "There are more tools available — hand-held calculators and personal computers with very powerful programs," he says. Such hardware can give alpha managers capabilities to crunch

numbers and come up with strategies that would have taken a lot more time before. Moreover, he adds, the crop of managers has improved. "The pool of brilliantly talented people is as high as it's ever been," says Ellis, whose 1975 article "The Loser's Game" in the *Financial Analysts Journal* helped define thinking on active versus passive management.

Even so, Ellis says, beta management is hardly dead. "If you have a disciplined approach, low costs, and well-thought-out goals, you can be reasonably assured of returns."

As experts try to sort out whether active or passive is the way to go, there are still nettlesome issues about definitions. As Muralidhar of Mcube has written in a HedgeQuest article titled "Greek Alphabet Soup and Risk-Adjusted Performance,"

**"Whether delivering
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“Alpha is ... very loosely defined in investing parlance — many people use alpha to mean returns in excess of the benchmark index with no information about how correlated these returns are to the benchmark.” One way to better define alpha is to look at revenue streams that are uncorrelated with the strategic asset allocation set up by the investor, he believes.

Another point about beta is that, despite today's hue and cry about separating it from alpha, doing so didn't seem such a big deal until 2000. That's when the technology bubble burst, the stock market dipped, and returns got anemic, making alpha a lot more important.

Off with Their Heads!

The demand for strong alpha performance is so intense that some major pension fund executives have threatened to fire money managers who provide only beta exposure while charging active-management fees. In today's world of flattened yield curves and low returns, taking such a tough line might be understandable, but it might be short sighted. “One problem,” says Green, “is that a lot of traditional, respectable beta managers get caught up in the hype and try to make themselves into hot-shot alpha managers. In the process, they might lose sight of the fact that, although the trend is to separate alpha and beta and glorify the former, the fact remains that they are very much interrelated, much like twin sisters.”

This doesn't mean that the heat's off, because the heat will stay on as long as a weak market is promising only single-digit returns. Whether delivering alpha or beta, the manager remains in the frying pan. Be warned, says Loftus, under these conditions “mediocrity will be unmasked more readily.”

What to Do?

Emphasizing that good beta management is essential, Arun Muralidhar says there are basically three ways for pension fund managers to handle beta.

First, they need to identify how they operate their pension funds. Muralidhar says the first way is to adopt a low-cost, low-yield methodology with the investor passively handing funds over to the managers to invest either in alpha or beta schemes. Doing so may ensure adequate returns against a benchmark with low errors. But the investor must expect returns that are not necessarily spectacular. The second model involves an all-alpha/no-beta method. “Some firms seem to be drifting to this model by keeping staff lean,” writes

Muralidhar in an article titled “Good Governance = Managing Alpha and Beta.” This scenario involves expensive hiring of outside consultants needed to probe for alpha returns. The last way is to go for effectiveness on both the alpha and beta sides. Costs will be less than the second model, but managers will need to know when to rebalance the portfolio on a regular basis.

Assuming there is a good alpha manager to drum up returns, the best way of managing the beta is to operate the pension fund like a sophisticated hedge fund, with all the attention and skill that implies. With this approach, constant reevaluation of asset allocation is imperative. “You can be a little proactive,” he says.

Another way to run the fund — presumably with less beta return — is to take more of a hands-off approach and let the beta drift or to simply rebalance it lockstep with each quarter on the calendar.

Going with a plan that ensures good beta management, Muralidhar believes, “will lead to better returns and lower fees/costs than searching for alpha from external managers.” As he says, “Hiring a good manager is a lot more important than getting the next 2 percent out of their funds.” Good managers will have to rebalance their accounts every quarter, if not sooner.

Institutional investors aren't the only ones who need to do some serious thinking about alpha and beta. “A lot of individual investors have been getting incredibly poor advice,” says Muralidhar. “The retail advisory business is going to have to improve its offerings as well.”

Optimal Portfolio or Optimal Strategy?

In today's global financial markets, with hot money sloshing from one country or region to another, some question whether beta management even remains important. In this view, beta becomes a relatively minor factor. “Woody” Brock, president of Strategic Economic Decisions, says that much of the current thinking about beta dates back to the 1960s and the development of the CAPM. Back then, says Brock, investments were basically cash or the market (consisting of any risky asset).

Getting a balanced portfolio itself was enough of a challenge. That world, he says, also assumed a “random-walk environment.”

Yet, Brock maintains, studies of market behavior over the

even though each market has its own beta.”



past 30 years “have shown definitively and decisively that we do not live in a random-walk environment.” Thus, investors “must replace the concept of the optimal portfolio with an optimal strategy.”

Such a strategy necessarily will be more active, seeking to get out of one market when it is high and enter another when it is low. Although Brock says that better technology hasn’t really affected the essential concept of constantly examining and shifting assets from market to market, global communications and the rise of more global markets do make it easier to jump in and out of markets around the world. “You crunch the numbers a certain way, and it tells you to lighten up,” he says. “You reduce your exposure to American stocks, and you go buy Russian bonds and South African stocks.”

By their very nature, global markets dilute the importance of beta as a basis for an investment strategy, even though each market has its own beta. Says Brock, “Once you realize that the fundamental concept is the right strategy — a strategy telling you to get in and out of markets — the concept of beta is radically changed and it is not even clear that it is useful because what matters is the rate at which I get out of market *t* and into market *j*.”

An Ongoing Search

So, at the end of the day, does a beta manager have to worry about his or her job? It depends. Since beta strategies are based

on exposure to a benchmark, any money manager who somehow can’t get the benchmark right “would have his business under a threat — period,” says PIMCO’s Loftus. At the same time, Loftus believes, no one can say whether managers who deliberately go after only beta are risking their livelihoods.

With flattening yield curves suggesting a tougher investment environment for the next few years, finding double-digit returns will be hard, even for the best managers. One example is hedge funds, which have boomed in recent years as ways to garner lucrative returns. As US Federal Reserve Chairman Alan Greenspan recently noted, “After its very rapid advance, the hedge fund industry could temporarily shrink, and many wealthy fund managers and investors could become ‘less wealthy.’”

Thus, investors are likely to keep searching for active managers who can generate alpha, putting more pressure on beta managers. Creative solutions are already being devised. Some advisers are responding by stretching beta management into more active areas, such as derivatives. So-called nontraditional beta strategies, such as bond overlays to minimize risk in varied portfolios, also can be applied.

Another reaction to today’s interest in alpha could be more emphasis on exchange-traded funds. Also in the cards, according to Green, are plans to define beta more robustly than by the familiar Fama and French three-factor model. Adding more factors might make figuring beta returns more precise, thus making it easier for beta managers to explain to their clients which returns are related to beta as opposed to alpha.

Moreover, how managers are paid for their work is another area yet to be sorted out, particularly in hedge funds. Green notes that it often isn’t obvious whether some alpha managers who command great remuneration for their returns are actually worth it. After all, history has shown that most active managers couldn’t beat the market once the fees and costs are considered. Despite the better technology that managers enjoy, it’s still not certain that today is any different.

The bottom line is that the current love affair with alpha doesn’t change the nature of either alpha or beta. “Beta will pay you some returns that are largely something you can bank on,” says Loftus. “Alpha may or may not.”

In that sense, beta may be the slow and steady tortoise that wins the race. ■

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Thrown for a

The flattening yield curve has some fixed-income investors feeling anxious, but experts say there are ways to eke out profits in this environment.

BY PETER GALUSZKA

Like most economists, Alan Greenspan is rarely at a loss for words. But even the normally effusive Federal Reserve chairman has had difficulty explaining why the yield curve—a term economists use to describe the overall movement of interest rates—has recently been rendered flat, as short- and long-term interest rates move in opposite directions.

“The pronounced decline in U.S. Treasury long-term interest rates over the past year, despite a 200-basis-point increase in our federal funds rate, is clearly without recent precedent,” Greenspan told the International Monetary Conference in Beijing in June, referring to the Fed’s aggressive rate-hike campaign of the past year.

Under normal conditions, when the Fed nudges short-term rates

higher, interest rates on longer-term U.S. bonds, those with five- to 10-year maturities, rise in tandem. This typically results in higher interest rates on mortgages and other long-term consumer debt.

A yield curve that slopes upward is good news for investors, who reasonably demand higher returns for longer periods to compensate for taking on more risk. A “flat

GETTY IMAGES



Curve

yield curve” is more than an economic oxymoron. It also presents a sort of investor conundrum, to use another of Greenspan’s comments on this topic, made earlier this year. Experts say that the flattening yield curve may signal bad times ahead. When the flat trajectory of the yield curve graph has become inverted (like a frown), that historically has been a sign of a coming recession. As of late June, the flattening trend was continuing.

So what’s an investor to do? Trying to divine the yield curve’s meaning, and just how bad times might become, has flummoxed many analysts. Already, investors are being affected by whatever is on the horizon. Speculators who profit by playing short-term returns

against long-term ones could get hurt, experts say.

Jeff Moore, who manages several fixed-income funds for Fidelity, advises bond investors to stay focused and look for prudent investment strategies. “If you have the right allocation, you have the potential to get the most of your returns,” says Moore, manager of Fidelity Investment Grade Bond Fund and Spartan Investment Grade Bond Fund, among others.

Global Forces at Play

Part of the uncertainty regarding the yield curve can be attributed to a relatively new phenomenon: great flows of foreign capital finding a home in U.S. securities, which influences short-term rates. A significant

IN A NUTSHELL

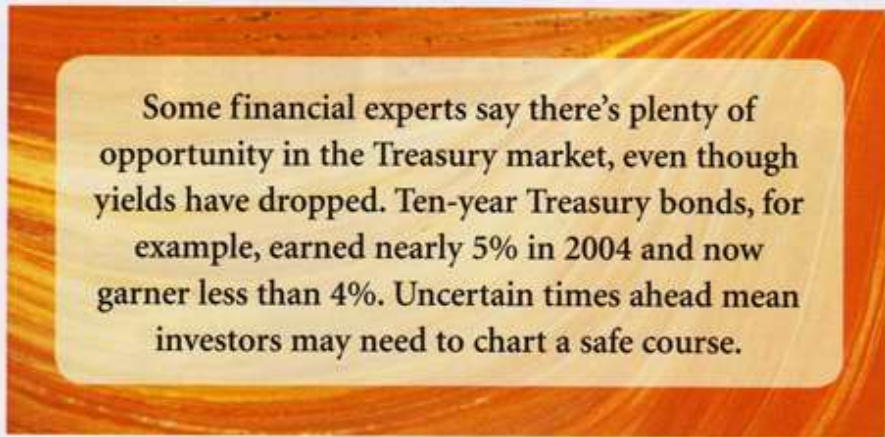
- The flattening yield curve may be a signal of bad times ahead, because historically lower interest rates often have been a harbinger of a sluggish economy.
- Lower-cost goods from countries like China and India, coupled with aging workforces and diminishing savings in countries like the United States, Japan, and those in Western Europe, may be contributing to the flattening of the yield curve.
- Fidelity’s Jeff Moore says that investors should not get spooked by the specter of negative returns. In the past, flattened yield curves have been generally short-lived and have tended to bounce back.

number of outstanding U.S. Treasury Bonds are held by non-Americans, and there doesn't appear to be any slowdown in buying by foreigners.

Countries with lower-cost labor forces, such as India and China, may be helping to drive down longer-term rates, according to some observers. Cheaper labor cuts the production costs of goods, keeping a lid on consumer prices and inflation. That downward pressure on prices not only benefits consumers, but can also drive interest rates lower on some fixed-income securities. China, for example,

new. The last time the yield curve flattened, or signaled worsening times, was in 2000; a recession followed in 2001. Soon after, the yield curve returned to the happy equilibrium where short-term interest rates were low and long-term interest rates were high.

Bankers benefit from positive yield curves because they can borrow cheaply at lower short-term rates and then lend those funds at higher long-term rates. They make a profit on the spread, the difference between the two interest rates. However, analysts aren't certain that the pattern will work the same way



Some financial experts say there's plenty of opportunity in the Treasury market, even though yields have dropped. Ten-year Treasury bonds, for example, earned nearly 5% in 2004 and now garner less than 4%. Uncertain times ahead mean investors may need to chart a safe course.

has flooded the global market with inexpensive products. Even if inflation begins to appear in other economies, cheap goods from China tend to keep overall inflation rates down.

Changing demographics in industrialized countries, including the United States, Japan, and those in Western Europe, may be another factor. Aging populations are decreasing the size of their labor forces. As the number of retirees in these countries increases, per-capita income drops, as do savings rates, decreasing the aggregate amount of capital available for investment. These factors seem to be pushing a global economic slowdown that is partly responsible for lower long-term interest rates.

Seeking Higher Returns

Bond analysts note that the dynamics affecting lower long-term bond rates are

with the current yield curve because of new factors, such as the increased globalization of the economy.

With long-term rates heading lower, investors are searching for higher returns. Because the current yield curve is producing a much smaller spread between long- and short-term interest rates, private investors are seeking other ways of gaining high yields.

Some are already moving into cash or high-quality municipal bonds because they can't get the returns they want from long-term Treasuries. At the same time, many are still investing in high-yield junk bonds, commodities, emerging-market funds, and foreign money markets. "People are continuing to take risks," says Mark Kiesel, executive vice president of PIMCO, an asset management firm in Newport Beach, Calif.

Housing Market Cooldown

One wild card in the yield-curve situation is the red-hot mortgage financing industry. Despite widespread concerns about housing price bubbles and risky mortgage financing schemes, the housing boom continues unabated. Analysts say that the gloomy times foreshadowed by the yield curve could have a big impact on the mortgage market.

For example, housing prices in some markets, such as San Francisco and Boston, are believed to have hit unsustainably high levels. Yet people continue to buy in these markets and could be hurt if property values fall well below their purchase prices. If the economy slows substantially, real estate prices might drop in a shorter time frame than normal, experts say. Corporate bonds could also be affected, because they are generally riskier than Treasuries.

Greenspan has tried hard to dampen the exuberance of housing investors, but mortgage rates have continued to defy the Fed and remain low by historical standards. In late June, for instance, the rate for a fixed 30-year mortgage was just 5.11%, according to Bankrate.com. Some homebuyers and speculators are trying out interest-only loans.

Some financial experts say there's plenty of opportunity in the Treasury market, even though yields have dropped. Ten-year Treasury bonds, for example, earned nearly 5% in 2004 and now garner less than 4%. Uncertain times ahead mean investors may need to chart a safe course. Moore says that many municipal bonds, which are not generally taxed by federal and state governments, may be good, inexpensive alternatives to consider.

Moore says that Fidelity is advising its clients that staying focused and keeping perspective are the best ways to ride out the storm. The first step, he says, is to help investors determine

From Barbells to Bullets

One strategy investors might consider is to switch from a so-called "barbell" approach to locking in good bond yields to a more direct "bullet" approach.

During routine times of positively and steeply sloped yield curves, many investors play the barbell strategy. Here's how it works: If you want a certain percentage return, pick bonds whose yields are different over time. You might want to invest in a two-year bond paying a lower yield and also in a 10-year bond that offers a higher yield. Thus, you can try to average the two around the yield you are seeking. "This strategy worked very nicely in 2003 and 2004," says Jeff Moore, a Fidelity portfolio manager.

In uncertain economic times, he says, a bullet strategy might be more successful. "If you decide the curve is too flat," he says, "you pick a target, say, at five years, and put all your money into a five-year maturity [bond],

Before investing, consider the fund's investment objectives, risks, charges, and expenses. Contact Fidelity for a prospectus containing this information. Read it carefully.

1. The fund may invest in lower-quality securities that generally offer higher yields, but also carry more risk, and in foreign markets that can be more volatile than the U.S. market due to political, economic and currency fluctuations risks. In addition the fund is considered nondiversified, investing in a relatively small number of securities, and tends to be more volatile than diversified funds and the market as a whole.

The municipal market is volatile and can be significantly affected by adverse tax, legislative, or political changes and the financial condition of the issuers of municipal securities. A portion of the dividends you receive may be subject to federal, state, or local income tax or may be subject to the federal alternative minimum tax (AMT).

Interest rate increases can cause the price of a debt security to decrease.

whether their allocation of bonds is appropriate based on their risk tolerance, time horizon, and investment objectives. "Get the right risk for you," he says. Second, don't get spooked by the specter of negative returns. In the past, flattened yield curves have been generally short-lived and tended to bounce back. Negative returns are possible in the bond market; it happened in 1994 and very modestly in 1999. Even so, says Moore, negative bond market returns rarely last more than a year. Of course, bond markets aren't guaranteed to perform exactly as historical markets.

What's Next?

Optimistic financial analysts believe that the yield curve will fall into a more positive sync when the Fed eventually starts lowering the federal funds rate. Although Greenspan said publicly in June that the tightening will continue, some believe the Fed may change

course early next year. In February 2006, the Treasury Department may reintroduce the 30-year bond, a move that some analysts applaud because of the strong demand for long-term U.S. Treasury bonds.

Meanwhile, bond buyers might take a look at tax-free municipal bonds, which have become increasingly attractive as T-bill rates decline. Munis typically are free of federal, state, and, in some cases, local taxes.

When it comes to today's yield curve, the best advice for investors seems to be to keep alert, stay cautious, and remain flexible. A new world order seems to be affecting yield curves in unusual ways. It's creating fresh challenges, but that, experts say, usually brings interesting new opportunities.

"The key is not to get contorted in this environment," Moore says. "If you have the right allocation, you're putting yourself in the best position to get the most of your returns. Even though the

rather than average them out. We have a whole team of analysts—both credit and quantitative—dedicated to fixed income seeking to buy the right bonds, and traders who specialize in buying bonds properly."

As a first step, Fidelity encourages investors to decide how much risk they want to take on according to their time horizon, investment objective, and personal tolerance. That determined, Fidelity provides a range of products that helps investors choose investment options that are suitable to their level of risk.

"For investors who want shorter maturity, we offer the Fidelity Ultra-Short Bond Fund, and for those who want longer maturity and potentially greater yield, we offer the Fidelity Total Bond Fund¹," Moore says. "And if you want something in the municipal bond space, you might consider the Spartan Intermediate Municipal Income Fund."

yield curve is flat and yields are low, there are places to go in the bond market that may offer compelling rewards." ■

Virginia-based writer Peter Galuszka is a former bureau chief with BusinessWeek.

In general, the bond market is volatile; bond prices rise when interest rates fall and vice versa. This effect is usually pronounced for longer-term securities. Any fixed-income security sold or redeemed prior to maturity may be subject to a substantial gain or loss.

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