

# STRATEGIC MANAGEMENT OF INVESTMENT FIRMS

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# Strategic Management of Investment Firms

- Investment management firms aggregate investor's savings and invest them to achieve the maximum expected return at the investor's chosen risk level.
- Passive mutual funds can be offered as exchange-traded funds (ETF's). ETF's are now the most actively traded stocks on the American Stock Exchange.
- Investment strategies generally can be categorized as either passive or active.

# Passive Strategies

- Passive strategies strive to match the investment return and risk of a pre-specified benchmark.
- The most common passive benchmarks are market indexes. The largest passive portfolio in the world is benchmarked to the S&P 500 stock index. Numerous other passive index portfolio benchmarks are now used throughout the world.
- Another major type of passive portfolio uses a “buy and hold” strategy comprised of a fixed group of securities. These passive portfolios are called “Holders”.

# The Logic of Passive Portfolios

- Although seen as foolish when they were introduced in 1972, passive portfolios have become very popular with investors.
- Why? Passive portfolios have out-performed the majority of active portfolios.
- How could this be? In mature markets, the large numbers of informed investors drive stock prices to levels reflecting the proper discounting of available information. Betting against this consensus involves a great deal of expense, and involves a great deal of risk.

# The Logic for Offering Passive Portfolios

- Passive portfolios are an economically useful option for investors.
- Managing passive index portfolios requires a high degree of portfolio engineering, and trading expertise. Large economies of scale are possible. Individual investors cannot do passive index management.

# The Logic for Offering Passive Portfolios (2)

- Passive management can be delivered with certainty.
- Passive portfolio management provides useful insight into active management.
- Passive portfolio management has proven to be a good business.

# Types of Active Management

- Systematic – Portfolios that are highly engineered and risk controlled. These portfolios conceptually begin with a benchmark and systematically deviate from it based upon quantitative methods for trading-off between expected excess return and performance-risk.
- Traditional – Portfolios that conceptually begin with a “blank sheet of paper” to which the manager adds stocks he feels are under priced. Diversification and performance-risk is less quantified, and sometimes purely qualitatively estimated.

# Types of Active Management (2)

- Hedge – Portfolios that hold both long and short positions. Portfolio construction among hedge funds is very varied. Some focus on individual stock judgments, others focus on broad economic forecasts. These portfolios are not well diversified.
- Market-neutral– This is a special type of hedge portfolio that equally balances long and short positions in order to eliminate broad market risk.

# Strategic Business Issues

- Currently, investment firms tend to focus on one type of portfolio management. Except for historical reasons, there is no good reason why this should be.
- Each type of portfolio management is attractive to some investors. Indeed, some investors choose a mix of portfolio types.

# Strategic Business Issues (2)

- Large investment firms may find important informational and knowledge synergies, and important economies of scale, by offering all major types of investment strategies.
- If one chooses to offer multiple types of investment strategies, there are innovative ways to combine them.