Successful portfolio implementation for smaller asset allocations

Russell Investments Research

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The demands on institutional pools of assets are as high as they have ever been. Interest rates remain low so the need for greater returns on the assets continues to increase. At the same time, the investment and regulatory worlds get more complicated and sophisticated over time.

Fortunately, in some pension jurisdictions, the funding burden has changed to place a greater focus on pursuing a going-concern target, allowing plan sponsors to spend more time managing return and volatility and less time worried about the constraints of solvency funding.

Regardless of jurisdiction however, managing return expectations is driving institutional investors to consider new and more complex sources of return. This requires a holistic approach to investment management, while maintaining access to the appropriate expertise and ability to monitor and oversee all investments in their portfolios. Yet, few investors have the time, expertise and asset base to access the necessary investment returns cost-effectively, with adequate diversification, oversight and risk control.

The Problem

While the issue of diversification is a significant problem for smaller asset pools, even investors of larger portfolios may struggle to access cost-effective diversification in their portfolios' smaller asset allocations. Efficient access to these allocations might be important to reach the investment outcomes needed.

Take, for example, a portfolio with assets of $1 billion. Let's assume there is an intent to invest 8% of the total portfolio into a satellite asset class (e.g. emerging markets equity or US high yield debt) to diversify the holdings and increase future returns. At the given portfolio size, such a strategy commits $80 million (m) to the satellite asset class.

To access reasonable economies of scale, the investor would likely need to allocate the entire $80m to a single investment manager. Doing so would typically involve a manager search process, followed by an investment that relies on the skill of the single manager selected and would expose the portfolio to a single investment style. Such an investment approach could expose the asset pool to a potentially volatile pattern of outcomes.

As an alternative, the investor may consider spreading the risk over multiple managers to diversify manager risk and investment style. This might include choosing, for example, four individual investment managers to adequately diversify the return streams. This approach would warrant multiple manager searches, leading to smaller mandates with each manager resulting in higher investment manager fees and a higher number of resources required to oversee each manager. In addition, the operational demands of moving capital between separate manager allocations would also increase.

This problem is, of course, more acute for smaller asset pools. Only the largest of asset pools have a sufficiently large asset and resource base to cost-effectively fund a fully diversified portfolio exposure in the smaller asset classes. In general, few institutional investors have the resources to manage and oversee multiple managers themselves. Further, many investors find that they lose significant economies of scale by spreading their assets across too many providers.

Long thought of as a solution only for smaller pools of assets, the use of multi-manager, multi-style investment products is gaining traction among more sophisticated investors of larger portfolios.

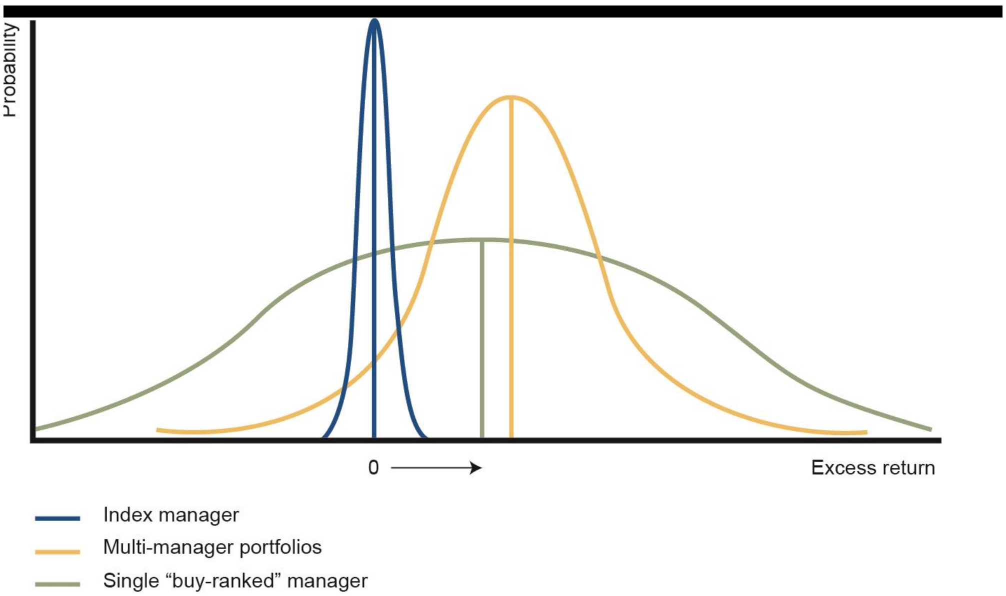
What is a multi-manager, multi-style investment product?

A multi-manager, multi-style investment product ("multi-manager product") seeks to understand how best to generate returns from a market or asset class. Based on the key return drivers identified, the provider will carefully choose a selection of active investment managers to manage portions of the multi-manager product. In doing so, each active manager is focused to seek returns in their specialist area of the investment markets.

This structure allows investors to access an asset class in a risk-controlled, diversified manner, in a single product that brings together multiple active investment managers of different styles, to diversify both manager risk and style risk.

Investors can more efficiently generate investment returns from a particular asset class, accessing specialist active management in a cost-efficient manner, while the burden of oversight for multiple investment managers is now largely outsourced to the provider of the product.

Exhibit 1: Distribution of excess returns



Source: Russell Investments Canada Limited. For illustration purposes only.

What are the benefits?

The benefits of using a multi-manager investment product can be extensive.

- **Diversification.** A key benefit of the multi-manager structure is diversification. The investor accesses a full spectrum of specialist active managers, reducing reliance on the success of a single investment manager or style. The manager selection and investment style risks are diversified so that the investor is less exposed to a single choice of investment style being in, or out of, favor and is also cushioned when a particular investment house underperforms or undergoes structural changes.
- **Security selection.** In a single-manager structure, investment returns may be dominated by a specific style, region or industry. It is common to have a manager appear to be an effective stock picker due to strong performance only to see that past returns were driven by a single factor that may or may not be replicated. In contrast, a multi-manager structure with a thoughtful approach to risk can allow for increased active risk from security selection while controlling for active risk from style, region or industry exposures. Combined with an expertise in selecting managers who exhibit superior stock picking skills, this structure allows investors to gather the full benefit of strong security selection while moderating unwanted exposure.
- **Economies of Scale.** A multi-manager product typically pools multiple investors into a single product. The provider of the multi-manager product will exercise the purchasing power of the collective assets of investors to access more economical investment management fees. This allows every investor to benefit from an efficient investment structure at a lower fee than they would likely be able to negotiate themselves for a similar implementation.
- **Wider expertise.** An expert in manager research and selection covers a vast range of products that a single investor may not be aware of or have access to due to size of investment. The manager of the multi-manager product may be able to include such additional **investment opportunities** in the product, making them accessible to all investors. Having access to a full suite of investment opportunities can be very important when managing risk in volatile markets.
- **Manager screening and monitoring.** An effective multi-manager provider will subject the investment managers considered for inclusion in their product to rigorous screening and due-diligence involving both quantitative and qualitative analysis. The provider will manage the relationship, maintain contact and visit the investment managers included in the product (and wider manager universe) on a regular basis. Because multi-manager products combine all these features into a single offering, the investor will see their **administrative burden reduced** when it comes to monitoring and oversight.
- **Simplicity.** Not only are the burdens of monitoring and oversight typically simplified, but so too are the operational concerns. Where an investor would be required to direct cash flow and transactions between multiple providers, the multi-manager approach allows the investor to deal with one provider only, simplifying operational cash flows, portfolio rebalancing and allowing **fewer transactions** at the investor level.
- **Responsive management.** With ever more volatile investment conditions, taking advantage of market movements requires investors to be nimble at all times. A properly structured multi-manager product will have a dedicated portfolio manager who can adjust allocations between investment managers, as well as tilt overall fund exposures to best take advantage of market opportunities and conditions. Multi-managers also have direct access to the portfolio managers that actually choose the securities to hold in the overall fund. This allows the multi-manager to gain a level of **transparency and insight** into the investment performance and strategy that is not readily available to the typical investor.

Beware the imposters

While there are many benefits to a multi-manager structure, inefficient implementation can undermine these benefits.

Is a ‘fund-of-funds’ the same thing?

A fund-of-funds is, in fact, a multi-manager product. The devil is in the details of the implementation. A fund-of-funds structure tends to be implemented by bringing together a series of ‘off-the-rack’ investment funds (“bottom funds”) and holding them in another single fund exposure (“top fund”). While this is a form of a multi-manager structure, there are pitfalls.

First, a layering of fund-of- fund structures may expose the investor to a layering of fees at both the top fund and the bottom fund level.

Secondly, using ‘off-the-rack’ products tends to lead to the inclusion of a series of generic investment mandates from each participating manager. This may result in the inclusion of the investment manager’s best ideas, plus lower conviction investments, creating an over-diversified portfolio.

Both problems can be overcome using a ‘customized mandate’ approach where the multi-manager provider stipulates a very specific mandate for each investment manager, focused on their best ideas and skill sets. In this structure, the multi-manager product will hold the securities directly rather than a series of other funds. This ensures that costs are not duplicated and that overall trading costs can be kept to a minimum.

In addition, the use of specialized mandates helps prevent an over-diversified product and ensures a focus on return-producing ideas. The multi-manager will balance the task of including enough investment managers to create adequate diversification without diluting the return proposition.

Layering vs. Portfolio construction?

As noted, part of the art of a successful multi-manager structure is ensuring that investment managers are brought together in an intelligent manner. A multi-manager’s philosophy and approach should not only demonstrate superior manager research and operational due-diligence, but also ensure that investment managers are brought together in a thoughtful and complementary way. Layering only managers with recent periods of strong performance may lead to a concentration of one investment style that is in favor at the moment, rather than managers that work well in combination through a variety of market conditions. Thus, layering generic mandates and non-complementary mandates will not likely provide the smoother ride that many investors seek. A strong multi-manager provider will avoid layering and seek to blend strategies that ensure market participation in all market conditions, as well as affirm that investment risks are managed and diversified.

Deep manager research and operational due-diligence?

Many products rely solely on high-level manager research. A quality multi-manager provider will scratch more than just the surface, demonstrating a disciplined and deep manager research process that is both quantitative and qualitative. Understanding investment managers from a discipline, process and organizational standpoint can be crucial to determine the ability of a manager to produce consistent returns. Further, a key risk associated with some investment managers is that they do not have adequate standards of care and control. Proper manager due diligence goes deep into the investment manager’s organization, including an operational and compliance due-diligence before entrusting them with client assets.

Objective and unbiased?

The multi-manager provider must be objective and unbiased in the selection of investment managers to participate in the multi-manager fund. This “open architecture” approach requires that no obvious conflicts should undermine the objectivity and integrity of the selection process. Creating structures that are sourced from a restricted investment manager universe, or from investment managers owned by the multi-manager, should be a cause for concern. A true "open architecture" multi-manager will not own an included manager, will not pay an investment manager to be included, nor will they receive compensation from an investment manager to be included.

Is the multi-manager product fully managed?

A quality multi-manager provider will ensure that all aspects of an investor's exposure are continuously managed. The overall economic positioning of many multi-manager products will simply be the exposure resulting from adding the exposures of each underlying manager. However, there is no guarantee that the sum of all parts would align with the multi-manager's overall view of the economy. Does the multi-manager provider have a view of the overall economy? They should.

A fully-managed multi-manager product should ensure that the combination of all manager positions still aligns with the provider's overall market view. An effective multi-manager will exploit active and passive investment management components for their respective benefits to adjust overall economic exposures. This ensures that the exposure of the product reflects the provider's economic views and risks while at the same time preserving the security selection skills of the underlying investment managers.

Without managing all aspects of the portfolio, the effective economic positioning of the portfolio might be an untargeted addition of potentially conflicting investment manager views.

Conclusion: What should I look for in a multi-manager product?

In simple terms, a multi-manager product is one that consists of multiple specialized portfolios from various investment managers. However, if implemented correctly, what sounds like a simple concept hides the reality of the hard work that goes on behind the scenes to target the delivery of the best possible return within well-defined risk constraints.

A strong multi-manager provider will blend investment managers with different, but complementary, investment styles and strategies to provide persistent and consistent investment returns across all market conditions.

The multi-manager provider should have a competitive advantage in identifying the appropriate investment managers, when to buy and sell their portfolios, as well as use them effectively to deliver better returns or risk characteristics. A multi-manager should have a well-articulated philosophy and process aligned with those competitive advantages and must be committed to delivering superior returns for clients.

In short, a strong multi-manager provider should exhibit the same compelling characteristics that you might look for in the underlying investment managers that the product is using, with a further awareness of risks and how to navigate the complexities of today's investment environment.

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Date of first publication: April 2019 INST-00970 [EXP 04-2021]