



Client case study

A European institutional investor adopts a novel way to implement their global equity portfolio to maximise their return potential and incorporate their investment beliefs

EXECUTIVE SUMMARY

One of our clients tasked us with improving the returns from their global equity portfolio. They had previously implemented their allocation via two global equity 'Responsible Investing' (RI) mandates because they want to invest in a manner which was consistent with good environmental, social and governance (ESG) practices. However, performance from both managers was disappointing.

The challenges

Small allocation size restricts the number of segregated mandates: The client likes hiring managers on a segregated basis as this gives them greater visibility into the underlying exposures, enabling them to manage risk more closely. However, their small allocation size limits the number of managers they can employ cost-effectively on a segregated basis.

"Spezialfonds" framework and administration: As the client's funds are held in a Masterfonds of a KVG¹, all third-party managers would normally require separate contracts with the KVG. Making changes requires extra authorisation and paperwork and can slow down the change process. Also, monitoring multiple managers, and analysing their aggregate exposure, can be complex and increases the level of internal resource required.

Limited universe of credible RI products: A big factor for the disappointing past performance was that the client was implementing their ESG agenda by picking explicit RI global equity products. This implementation approach limited the choice of good managers that were available as many managers in this universe place more emphasis on the RI features themselves than on a high-quality investment process.

All of these factors influenced the client's decision to originally hire only two global equity managers.

¹ Previously known as a KAG ("Kapitalanlagegesellschaft"), a KVG ("Kapitalverwaltungsgesellschaft") is a regulated capital management company which specialises in the administration of investment assets.

The solution

The client employed Russell Investments to build and manage a bespoke portfolio consisting of three parts:

1. Employing over ten active global or regional equity managers (or 'sub-advisors')

Russell Investments believes that with good manager research, it is possible to find active managers that outperform in global and regional markets. Both global and regional managers are chosen on their ability to produce active returns, and managers with complementary processes and search universes are combined to produce returns which aim to outperform a global equity index over the long term. The benefits of this approach are:

- › **Increased chance of outperformance from access to a wider universe of credible managers.** Russell Investments's starting point is the full universe of global and regional managers, and it not restricted by a region or 'RI' label. Having researched about 880 global equity products and over 3,800 regional equity products over 2015, the starting universe is over 500 'Hire' ranked managers².
- › **Reduced alpha volatility.** The outperformance from different manager styles and processes should follow different cycles and therefore should yield returns at different times. As an example of complementary processes, global managers benefit from having a wide universe of stocks to choose from and can also add value from country selection. Regional managers benefit from more intense bottom-up research in narrow markets and tend to invest in small- to medium- size stocks which are usually outside the research universe of global managers.
- › **Higher level of outperformance over the long term.** Pursuing more aggressive stock-picking approaches can lead to higher outperformance over the long term. However, the unconstrained, aggressive approach of a single manager may result in performance too volatile for many investors to tolerate in isolation. Combining the returns from complementary managers helps to bring the overall volatility level down to acceptable levels.

2. Implementing the insights from the sub-advisors through a single trading desk

To overcome the challenge of implementation within a KVG framework, Russell Investments proposed a process labelled 'Enhanced Portfolio Implementation'. In this process, the managers do not trade themselves but send their portfolios and trades to Russell Investments as the centralised portfolio manager for the overall portfolio. The only contractual partner of the KVG is Russell Investments, who conducts all the trading on behalf of the client's portfolio.

This 'Enhanced Portfolio implementation' approach provides the following benefits:

- › **Lower administration-related costs and swifter changes** as only a single contract is required—not more than ten contracts as in this case.
- › **More cost-effective execution** as trades are aggregated across all the mandates through a trading desk which traded €1.9 trillion over 2015.
- › **Reduced costs** by avoiding redundant trades caused by one manager selling a stock and another buying the same stock.
- › **Access to managers** that may be closed to new business or unwilling to take on small mandates on a segregated basis at a price that the client finds acceptable.

²Figure as at 31 March 2016.

3. Adjusting the trades/holdings to take into account the client's ESG requirements

The benefit of the centralised-dealing approach is that the client can incorporate their ESG beliefs – in this case by excluding stocks with specific ESG characteristics – without distorting each manager's underlying process and outperformance potential.

The outcome

Despite a tough environment for active management over 2014, the portfolio outperformed its benchmark by over 1.1% (gross of fees) for the one year ending 30 September, 2015.

Just as important as the results, the client is more confident in their new structure. They believe that their new structure increases their chance of capturing outperformance over the long term. The managers are chosen for their ability to generate active returns and the universe from which these managers are chosen is not restrictive.

The novel central-dealing approach allows them to access multiple, complementary managers on a segregated basis cost-effectively. This allows them to benefit from the lower alpha volatility that a multi-manager approach offers and enables them to pursue more aggressive mandates in the pursuit of extra returns, while keeping overall risk to an acceptable level. This implementation approach also enables them to integrate their beliefs into the portfolio easily without having a detrimental impact on performance.

For more information: Call Russell Investments on +49 (0) 69 667748273 or visit russellinvestments.com

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