Multi-manager - The Case for diversification

20 October 2006
The Star Business Report


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Trustees are in a quandary. They are often not equipped with the necessary tools – neither time nor skills - to choose the ideal fund manager to suit the specific needs of their fund, particularly under the current market conditions. In response, their answer has been to focus almost exclusively on one specific factor when considering the appointment of a manager - past performance.

Trustees are answerable for their decisions, and have to be transparent when reporting back to their members on how they arrived at those decisions. Past performance may seem like a good idea at the time – but six months later if the future performance has not matched the past, explaining the decision may be a tough task. So they employ consultants, typically pension fund valuators who are adept at calculating the future liabilities of the fund.

"But," says Warren Brown, head of fixed interest and alternative investments at SYmmETRY Multi-Manager, "these liabilities can only ever be approximated – and this fact dictates how the assets are to be managed. These advisers can advise on issues like the benchmark, style and measuring the risk profile of the fund – but they cannot adequately take it a step further and select the best fund managers."

The reality is that all fund managers are different, and their differentiation is important to them. Neither trustees, nor their actuary advisers, are equipped to decide on which to select and how to reduce risk by combining different fund managers in a way that reduces overall volatility instead of unintentionally increasing it.

"That's our core activity," explains Brown. "Multi-Managers spend a lot of time researching issues of style and benchmark selection."

These are the fundamental decisions a trustee has to make – and they are issues which have generated a great deal of misinformation over the years. Brown says there are at least 10 benchmarks being used for equity performance alone. Which to choose?

"The next question is: should one down-weight resources in one's benchmark, as resources are so volatile? There has evolved a conventional wisdom that pension funds should down-weight resources, but I question why. This argument tends to get blindly applied to all pension funds, irrespective of its individual risk profile.

“Multi-Managers perform this type of research, and are able to blend fund managers in a way which achieves the optimum risk/reward profile for individual funds,” says Brown.

That’s not to say Multi-Managers do not take cognisance of the consensus, he says: “It cannot be ignored in a prudently-managed fund, but at least these questions are adequately addressed.”

Another debate where Multi-Managers can add value is that of investment style.

Analysis of the past performance of active managers, compared to passive managers, suggests many do not give an adequate return, says Brown, though some have performed particularly well. This points to the need for fund manager selection.

Unfortunately past performance is not necessarily a good indicator of expected future performance.

“People who follow past performance believe in the principle of performance persistency – if they pick a winner, it will remain a winner. The tricky question is, for how long?”

Quite apart from markets moving away from an investment style, there are softer qualitative issues at play, such as the overall culture of the organisation , who the key decision-makers are within the organisation, how stable the organisation is, what the quality of the research undertaken is like and what the levels of staff turnover are.

“One also has to look at the impact of a fund’s liabilities – the fund manager may have to liquidate assets at inconvenient times to meet unexpected payouts. Therefore one has to look at a longer time frame in analysing the performance of a fund manager.

These may be far more important then past performance.”

But Brown does not ignore short-term performance, or peer performance. “One has to evaluate how a fund manager is performing relative to its peers. But should one fire a manager simply because it under-performs over one quarter? You cannot make that decision based on quantitative analysis. On the other hand, a fund manager may suddenly lose 10 key staff, and even though the performance hasn’t yet reacted, there is a case for changing manager,” he says.

History has shown that manager's change and key decision-makers within the organisation leave.

“This is the major rationale for using Multi-Managers – to diversify away from a reliance on a single manager. The fact that a single fund manager will eventually under-perform is exactly the risk a Multi-Manager seeks to avoid.

“But even within a single style, such as active, you cannot simply add three fund managers together and expect to get the average of their returns. Their combined position is very different to their individual positions,” adds Brown.

Even within one Multi-Manager house there can be different strategies: one method is to simply take a number of top-performing fund managers and split the assets equally between them; another is to split assets into asset classes and design a blend around a single, anchor fund manager and to offset the risk with some satellite, non-benchmarked managers.

All Multi-Managers aim to address these risks on behalf of trustees, but how one blends several fund managers becomes itself an issue.

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