

Demystifying Multi-Managers

There has been a lot of interest in ‘multi-manager’ investing recently, as advisers, researchers, platforms and, importantly, investors recognise the important risk-reduction benefits that can result from diversifying a portfolio across a range of investment managers.

Whilst the benefits of diversification across different investment managers (and asset classes) are appreciated by most advisers, what is less clear are the important differences between the various forms of multi-manager investing, and the impacts on both clients and advisers.

This article discusses the objective of blending managers, and the process used to construct a robust multi-manager strategy. A key conclusion is that multi-manager strategies are not simply about combining a few managers, rather a high degree of qualitative research and analytical insight is required to ensure clients get the best portfolio possible.



Manager Blending: Science versus nonsense

Client portfolios are generally constructed using a number of investment managers within each asset class. If managers are using different decision making processes, when one manager under-performs, the others may add value. To exploit these diversification benefits (ie to reduce risk by combining managers), you must ensure that the managers selected are sufficiently different, otherwise they will generate similar patterns of relative performance.

Once you identify which managers you believe have the capability to out-perform over the long-term (or over a full cycle of market conditions), you must consider how each manager’s style compares to other managers you have selected, and make sure they are sufficiently different. The weightings to each manager should then be determined so that the portfolio is not overly biased towards one particular style. This should result in a portfolio of investment managers that are all expected to outperform over the long-term, but which have complementary styles that help to minimise volatility (relative to the market) over shorter time periods.

Why do investment styles matter?

Investment styles matter because different styles perform differently at different times. This is the reason why no single manager can be the best performer at all times and over all market conditions. To understand why this is the case, let's have a closer look at styles and how they impact performance.

Understanding Investment Styles

When looking at investment styles it is important to realise, although there is no single way to define an investment style, many managers can be grouped into general categories, with the most familiar being 'growth' and 'value' approaches. Some of the general characteristics of value and growth styles are detailed in Table 1.

As can be seen from the table, the two broad styles often use opposing methods in selecting stocks. However, it is not just as simple as classifying managers as either 'growth' or 'value' managers – there is any number of differences between managers within the same broad style.

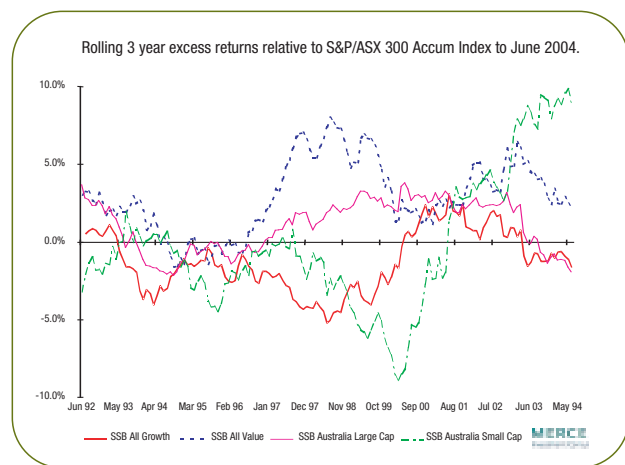
For example, one value manager's process may result in a focus on stocks with a high dividend yield, and another value manager may not even consider dividend yield in selecting their stocks. This may result in different portfolios for two value managers. Further, a manager's process can also be biased not only by the above characteristics, but also in the average size of stocks they target – large caps, small caps, or anywhere in between.

As a result, it is not only a manager's ability to pick stocks which determines what ends up in their portfolio, but a manager's style also has a large impact.

So what impact does style have on performance?

As detailed above, there is no single way to define a manager's style. So how can their style have an impact on performance?

The below graph shows how the different segments of the market (Value, growth, large cap and small cap) have performed relative to the broad S&P/ASX300 Index since 1992.



As you can see, each segment has performed quite differently at different times, with all experiencing periods of over and underperformance. It is this variation which can have a significant impact on how a manager performs at any given point in time, and why any considerations of a manager's performance should be made in the context of their process and philosophy. Therefore, contrary to popular belief, good managers do not go 'hot' and 'cold', rather their short-term performance can be influenced by the impact market conditions have on their investment philosophy and process. However, over the longer term, good managers should be expected to outperform.

Table 1	Growth	Value
Approach	Favour stocks with future medium to long term earnings growth that is expected to exceed that of the average for the market or industry in which they operate	Favour stocks that appear fundamentally sound, but are trading at a discount to fair value.
Valuation time-frame	Focus their efforts on evaluating the potential for growth over 3 to 20 years	Often do not forecast more than 3 to 4 years into the future & use conservative future growth & terminal value assumptions
Characteristic ratios	Low dividend yield; high Price to Cash Flow; High Price to Earnings; high Price to Net Tangible Assets; high Price to Book;	High dividend yield; low Price to Cash Flow; low Price to Earnings; low Price to Net Tangible Assets; low Price to Book

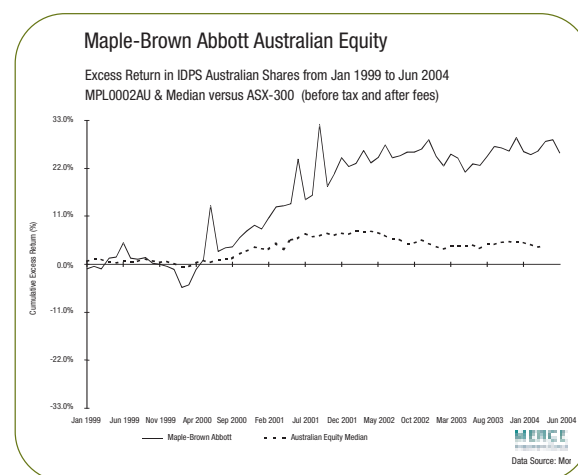
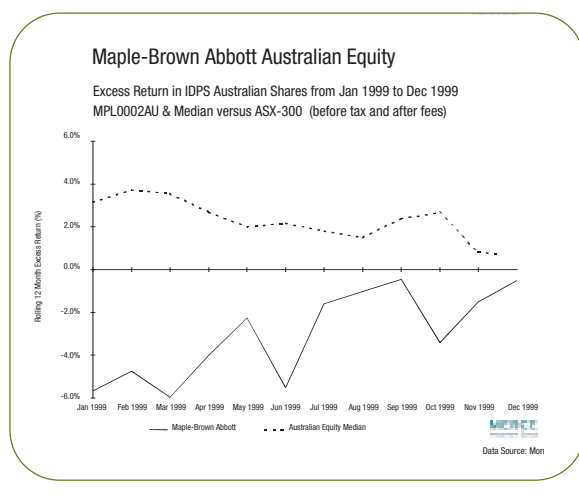
An example of style and performance – Maple-Brown Abbott

For example, consider Maple-Brown Abbott, who has been one of MLC's Australian share managers since 1992.

Maple-Brown Abbott have a strong value style, which was significantly out of favour during the 1998-2000 period. (the end of the great bull-run that saw companies trading at Price-to-Earnings ratios well above historical averages). Quite simply, Maple-Brown Abbott did not see value in many of these expensive stocks and positioned their portfolio accordingly, even including resource companies, a sector that many investors shunned as 'yesterdays' investment while they bought the tech story.

However, as we all know, the tech boom came to an end in early 2000, and since that time value styles have outperformed

their peers. This can be seen in the graph below which shows their huge outperformance since early 2000.



There were no major changes at Maple-Brown Abbott during this period (ie their commitment to a value based investment philosophy and process, no significant staff changes, or ownership changes), so what caused this dramatic turnaround? The change in market conditions in early 2000 meant value stocks came back into favour, which improved Maple-Brown Abbott's relative performance. This emphasises a highly important point - when assessing a manager it is critical to know when and how their investment style impacts on their relative performance.

So if style has such a big impact on performance, how should you consider a manager's style when building a truly diversified portfolio?

Manager Blending – Where's the Science?

As indicated above, different stocks perform differently at different times, and it is very difficult to consistently and accurately predict which type of stocks are going to outperform at any point in time. As a result, in order to get a well-diversified portfolio, it is important to control style biases

within the portfolio. This then reduces the risk of underperforming the market, without impacting your overall long-term returns. What becomes obvious is that when constructing a portfolio, you must have managers with different styles. Contrast this to some multi-manager funds which may have several managers but with similar styles and processes, resulting in a portfolio with minimal style diversification. These portfolios run the risk of significantly underperforming when, as will inevitably happen, that style goes out of favour.

Unfortunately, the process of blending managers so that you control for style biases is not an easy task, and requires an in-depth understanding of each manager over long periods of time. A simple

example is where you have a value and growth manager who both have a bias towards large cap stocks. When small caps outperform large caps, your portfolio will lag the broader market.

A more complex example involves making sure that you cover all aspects of style. Each manager has a unique investment philosophy and process, which results in different tilts. For example, Dimensional Fund Advisers generally have a much more pronounced deep value bias than Lazard, even though both are considered value managers.

Thus to attain a well-diversified portfolio, you can't simply have equal weightings to each manager. Blending managers can be compared to baking a cake. Having all the right ingredients is not enough – if you just put equal amounts of each ingredient, rather than putting them together in the right proportion, you'll end up with something that's quite inedible. Similarly, combining managers in the right proportions in a portfolio makes sure you get the right result for your clients.

The consideration of appropriate weightings when blending managers is often ignored by many multi-manager providers, as they fail to adequately diversify portfolios across various styles and therefore forego risk-reduction benefits.. It is only through an in-depth analysis of each manager's style, and by understanding the impact this has on the overall portfolio over time that the optimal weights within each asset class can be set. This understanding only comes with a sophisticated approach to manager research, fully understanding a manager's role within the portfolio and rigorous quantitative analysis over time to determine the right mix.

Conclusion

Understanding different investment styles, how they perform and how they impact an overall portfolio is a very difficult one for investors to understand. This is why it is critical for investors to use the expertise of an investment professional in building their portfolios.

Multi-manager specialists are in the best position to create portfolios, they have an in depth understanding of their managers, and are able to blend them in an optimal manner (ie to minimise expected volatility as a result of changes in market conditions). Understanding the role that style plays is very important as it helps avoid the knee-jerk, and often value destroying, reaction to fire managers when performance appears to have softened.

Unfortunately, not all multi-managers are utilising the required insights, but merely combine a few managers in their multi-manager offers and disregard the full implications of their decisions on clients, and advisers. With almost 20 years of experience at creating multi-manager products, MLC is ideally placed to:

- understand the impact of style on a portfolio,
- build portfolios that are designed to take full advantage of each manager's style, and
- ensure that the final portfolio is appropriately diversified.

Our desire is to assemble a group of managers that are individually exceptional, and together provide the highest likelihood of achieving a targeted aggregate risk and return profile.

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