

# Demystifying Multi-Managers

## Managing Change - The Hidden Costs

There has been a lot of interest in 'multi-manager' investing recently, as advisers, researchers, platforms and, importantly, investors recognise the important risk-reduction 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 follows on from our original article titled "What differentiates Multi-managers" (May 2004), and looks at how the different forms of multi-management can have a significant bearing on managing change within your clients' portfolios.



Keeping pace with the constant change in investment markets takes time and resources, but is essential if your clients' portfolios are to remain best positioned to meet their needs and goals. All portfolios will need restructuring at some stage, and more often than not this will involve replacement of an investment manager(s). How you plan for and react to such change influences not only your clients' outcomes, but also the efficiency of your own business.

The key issues to any change within your client portfolios are:

- The time and resources needed to identify the opportunities and / or need for a change
- Ensuring changes are identified in a timely manner
- Ensuring changes are implemented without delay to minimise 'time out of the market' and the 'opportunity cost' of having a sub-optimal portfolio; and
- Ensuring changes are implemented in the most cost-efficient manner for better client outcomes.

The art of 'transition management' (the process of planning, coordinating and implementing a change in a portfolio) is complex, and often overlooked. However, the efficient and cost-effective management of any change to your client's portfolios is critical to ensure your client portfolios do not 'leak' valuable returns.

The ability to identify the catalyst for a manager change is clearly a key input into transition management, and involves a great deal of

ongoing manager research and monitoring. Given the demands on advisers' time, it is often not possible to dedicate the time and resources necessary to undertake such research and monitoring. But it is not just people and dedicated resources that matter when considering how you manage change, having the right investment structure in the first instance can also make a big difference.

## Investment Structure and Transition Management

There are 3 main investment 'structures' you can recommend to your clients to gain access to multiple investment managers:

- (1) A portfolio of single manager funds (possibly through a wrap or master trust);
- (2) A fund-of-funds (FOF) portfolio; or
- (3) A manager-of-manager (MOM) portfolio.

Which investment structure you recommend to your clients impacts greatly on how well change is managed within your clients' portfolios, and consequently may have a significant impact on their investment performance.

Where your clients invest in a portfolio of single manager funds, you are responsible for the manager selection and ongoing monitoring of your clients' portfolios. Whilst many of your client base will be invested in the same fund(s) based on your recommended investment list, it is unlikely that you will have the time to review all your clients' portfolios when a requirement for change is identified. This is understandable, because the substantial time resources required to recommend a change (via a Statement of Advice) and gain approval from each client should not be underestimated.

As a result, regardless of the quality of research and timeliness of reaching a decision about changing managers, there is likely to be a delay between identifying the need for a change and implementing this for all clients. This gives rise to a possible 'opportunity cost' of your clients being in a sub-optimal portfolio. In addition, irrespective of the efficiency of any platform, there is likely to be significant work and cost involved in implementing the change across your entire client base.

In comparison, within a FOF or MOM portfolio once the provider identifies the need for a change, it is implemented quickly and efficiently for all clients without the need for you or your clients to be actively involved. This significantly reduces the potential opportunity cost involved with the change, and means your clients have an optimal portfolio at all times, which can have a significant bearing on their investment returns.

### **Example:**

*In October 2002, MLC terminated Perpetual Investments Australia on the day that Peter Morgan announced his resignation from Perpetual. MLC was able to transfer the portfolio to DFA quickly and efficiently because MLC's constant management of its 'reserve list' of managers had already allowed the identification and thorough research of a replacement manager.*

*However, to implement the same change across all of an adviser's client base (outside of a FOF or MOM) would involve a Statement of Advice for each client, and probably take a number of months. (In some cases this change would not occur until the client's next annual review).*

## Ownership of Assets

As detailed in our original article, "What differentiates Multi-managers", both a portfolio of individual funds and a FOF have similar arrangements, whereby the client or FOF provider own units in a number of investment funds rather than owning the underlying securities (ie shares, bonds etc) directly.

As a result, whenever a change in manager is required, money is redeemed from one or more of the existing single manager funds and reinvested into either a new fund or across the existing funds (depending on the strategy being implemented). This involves the liquidation of securities in the outgoing fund and subsequent purchase of new securities in the new fund, even though in many instances both the old and new fund will hold many of the same underlying securities! Therefore, despite the commonality of holdings, all securities are sold and repurchased, incurring:

- Transaction costs (buy/sell costs when moving between managed funds).
- Capital gains tax implications on the entire transaction;
- Unnecessary market trading, which may cause the value of the underlying securities to change, particularly if large parcels of securities are illiquid stocks are involved (known as 'market impact').

These costs can have a significant impact on your clients' portfolios, causing performance drag, and potentially reducing their overall returns.

However, these problems can be overcome with an efficiently implemented MOM portfolio. Within a MOM portfolio, the provider retains ownership of the underlying securities, which means that common securities can be transferred 'off-market' without being

bought and sold, and therefore not incurring brokerage (nor any buy/sell costs as there is no trading in underlying investment funds). For example, in a typical transfer between two Australian share managers, around 60-70% of the stocks may be common, and can be transferred rather than traded.

Furthermore, an experienced and skilled transition team (such as MLC) may also be able to transfer non-common stock within crossing networks run by specialist transition managers, further reducing the number of stocks that require physical trading in the market.

As a result, within a MOM portfolio, there is significantly less trading of the underlying securities and performance drag is minimised compared to non-MOM solutions.

**Example:**

*In April 2004, MLC transitioned approximately \$430m of listed property securities from Lend Lease Real Estate Investments to HSBC Asset Management when HSBC was appointed as a manager to MLC's listed property portfolio. Over 80% of the assets were transferred off-market, greatly minimising transaction costs and unnecessary market trading as part of the transition.*

*Due to MLC's scale, transitions tend to involve large sums of money and reduced brokerage fees for those securities not transferred off-market. In contrast a transition within a FOF would likely be on a much reduced scale, involving the redemption of units from the outgoing fund, and purchase of units in the new investment fund. This is similar to any change in single manager funds and investors will incur the buy/sell differential in changing funds in both circumstances. Using the average buy/sell differential for wholesale Australian listed property securities funds of approximately 0.45% (Source: MorningStar), a transition of just \$43m within a FOF portfolio would only result in just over \$42.8m worth of units being purchased in the new investment fund. This is an immediate loss of around \$190,000 in transaction costs alone to investors.*

*In addition, capital gains tax will be payable on any gain when redeeming units from the outgoing fund. Whilst capital gains will eventually be payable in any structure, the deferral of capital gains available within a MOM portfolio can be an advantage. If there was say \$5m of unrealised gains on the outgoing Fund, the tax payable would be \$500,000 (for superannuation funds, assuming all units had been held for more than 12 months). If the capital return on listed property securities is 3.5% p.a. (based on S&P / ASX 200 Property Price Index over the 10 years to 31 March 2004), the 'lost' capital appreciation in the first year by bringing forward the capital*

*gains will be \$17,500. This 'lost' growth will compound each year.*

## How quickly can the change be implemented?

Another impact that is often overlooked when investing in a portfolio of single manager funds or a FOF portfolio is the speed with which a change is implemented, once the decision has been made to make a change. Because both single manager funds and FOF portfolios invest in a portfolio of underlying investment funds, they are subject to 'cash drag'. That is, clients will be out of the market while they wait for the proceeds of their redemption to be received and used to acquire units in the new investment fund. Despite switching functionality within platforms or careful control within FOF portfolios, clients could still be out of the market for at least 1 day, and potentially much longer with a portfolio of retail investment funds.

This delay could have a significant impact on your clients' returns. It is not unusual for share markets to rise or fall by more than 1% on any one-day, and occasionally by much more! For example, over the last 10 years the daily price return for Australian shares has ranged from -6.8% to +6.1% (Source: MLC Investments based on S&P / ASX 300 Accumulation Index). Therefore, being out of the Australian share market for just a day or two could have a significant bearing on your clients' returns.

Compare this with a MOM portfolio, where the provider holds the underlying securities. As a result, your clients' portfolios remain fully invested, and are not subject to the risk of missing out on even one day's potential strong performance. Your advice to the client, and their expectation of being invested in assets such as shares and bonds should not be undermined by poorly executed transitions, which could potentially leave a portfolio out of the market at just the wrong time!

## Conclusion

To ensure your clients' portfolios remain optimally invested, you need to ensure the investment structure and provider chosen can make strategy changes quickly and efficiently. Keeping costs down to minimise the impact of such a change requires dedicated resources and expertise. The table below highlights the inefficiencies explained in this article that both a portfolio of single manager funds and a FOF portfolio can have compared to MOM portfolios when it comes to managing the inevitable change within clients' portfolios.

The MOM structure provides the best potential outcomes for your clients, as it efficiently manages most inefficiencies, and therefore can minimise any 'implementation leakage' in transition management.

However, whilst the MOM structure is ideal for your clients, it is critical to partner with the right provider who has a skilled and experienced transition management team to ensure the process is undertaken as efficiently and cost effectively as possible. Many new MOM offerings have not yet experienced large transitions within their portfolios, and have untested transition management skills. MLC, on the other hand, has a dedicated implementation team, which use their proven skills and experience to focus on obtaining the full benefit of the MOM structure for your clients, and in turn maximising your clients' long term returns by ensuring any 'leakage' is minimised.

Feature	Single Manager Funds	FOF Portfolio	MOM Portfolio
Ownership of underlying securities	No –units (and thus securities) will require liquidation	No – funds units (and thus securities) will require liquidation	Yes – common securities can be transferred 'off-market' greatly minimising cost
Direct costs	Buy / Sell costs – up to 60 bps on changing underlying fund	Buy / Sell costs – up to 60 bps on changing underlying fund	Brokerage fees only paid on assets sold and bought, typically less than 10 bps each way
Capital Gains Tax	Immediate crystallisation of all gains on sale	Crystallisation of all gains and included within next distribution	Common assets are not sold, generally crystallisation of gains only on securities sold.
Loss of market exposure*	At least 1-2 days for wrap & mastertrusts, longer for retail investment funds.	Can be managed, but up to several days whilst awaiting cash proceeds	Minimal – maximum market exposure maintained
Delay in moving to new manager*	Potentially months to move to new manager subject to client review. Statement of Advice required.	Minimal and simultaneous for all clients – termination and hire of new manager can be fast (days)	Minimal and simultaneous for all clients – discrete mandates means termination and hire is fast (days)

\*Both 'opportunity costs'

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