MULTI-MANAGEMENT APPROACHES

Active allocation is an asset – not a headache

Asset growth by multi-managers in recent years is testimony to their ability to create optimal portfolios of alpha and beta and capture the best of traditional and alternative investment managers, writes Christian Elsmark

Few things are more fragile than investment memory. It is constantly eroded by the shifting tides of capital markets. As investors, we would rather scan the horizon than look back. As humans that is a good thing (it is the basis of our optimism), but it also means we may believe in conventional wisdom.

Steven Levitt and Stephen Dubner, University of Chicago economist and New York Times journalist respectively, in their 2005 book Freakonomics demonstrated that if an idea is simple enough to be internalised by many people, and that idea seems to be in the self-interest of the average person, then that idea often becomes conventional wisdom, whether it is true or not.

For instance, conventional wisdom assumes that emerging markets are inefficient and therefore a greater percentage of active emerging markets managers should deliver relative out-performance against their index than active managers investing in developed markets. However, as figure one illustrates, this is not necessarily the case.

Put simply, conventional wisdom can be wrong and people make mistakes when they invest. One aspect of human behaviour is overconfidence which, for instance, causes people to neglect proper diversification. Overconfidence can lead investors to concentrate their portfolios too heavily in a few areas that they feel are going well. Home bias, excitement for emerging markets, chasing past performance, or only trusting recognised brands, are all examples of the risks of overconfidence. Just think back to how many investors in 2000 thought they had well diversified portfolios but in reality had a greater exposure to technology stocks than their risk profile would have been comfortable with.

A study by Busse, Goyal, and Wahal (2005) on US fund managers over 10 years to 2003 also found that the stronger the pre-hiring returns of an investment manager, the weaker the post-hiring returns. This demonstrates evidence of cyclicality in relative returns of investment managers.

BEYOND THE NUMBERS

Investors must recognise that fund managers' performance is cyclical and therefore any manager selection process must try to understand the causes of past under and over performance. Evaluating fund managers means looking beyond the performance numbers, as past results do not guarantee future results.

Success is limited and fleeting. Any quest for sustainable alpha must recognise the unfortunate truth that diversification makes sense as no asset is "safe" from falling in value. However, the shortcomings of a classic long-only exposure to both equity and bond assets are increasingly evident in an era of low expected returns and moderate inflation. The ever more urgent quest for capital preservation and extra yield has prompted investors to seek out active, highly flexible strategies with exposure to low cross-correlated assets.

Lately, this so-called "new balanced approach" has become a big topic in just about every asset management company. Indeed, a paradox about this "new balanced investing" topic is that there is nothing new about it – about the benefits of trying to find different sources of added value, that is. What has changed, however, is that the opportunity investment set has become bigger and more diverse.

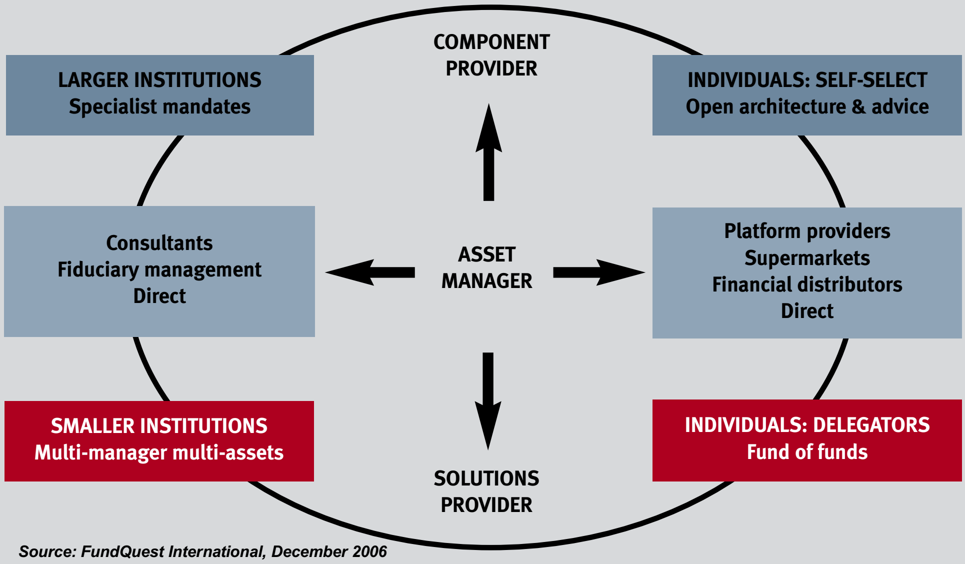
Arguably, more significant for the financial industry is that new forms of multi-asset management might hasten the decline of traditional mainstream balanced

Figure one: Percentage of funds underperforming the index (for period ending 30-09-06)

Fund category	Comparison Index	One-year	Three-year	Five-year
International equities	S&P/Citigroup PMI World ex US	62.71%	79.04%	78.19%
US large caps	S&P 500	70.32%	68.05%	70.95%
Emerging markets equities	S&P/IFCI Composite	73.85%	77.94%	89.61%

Source: S&P; reported in FTfm October 23, 2006

Figure two: Understanding customer needs and the competitive landscape



Source: FundQuest International, December 2006

managers. The asset growth by multi-managers in recent years is testimony to the acceptance that they can create optimal portfolios of alpha and beta and capture the best of traditional and alternative investment managers. In addition, by providing proper unfettered diversification and engaging professional manager research experts to find the outstanding managers, multi-managers enable better governance to investors who lack the resources and experience to face the challenges of tomorrow's changing market conditions.

THE RIGHT BALANCE

The notion of maintaining a properly structured portfolio with the right combination of alpha generating specialists is simple to appreciate, but difficult to implement as it requires ensuring the right balance between market risk and manager risk. In fact, some investment firms historically decided this challenge too difficult and maintained an approach whereby the index represented the "equilibrium" allocation with the only added value from manager/security selection. However, academic evidence of the benefits of style management has provided support to the multi-manager/multi-style approach. New balanced funds are not benchmarked, but typically have a target or absolute return focus.

At FundQuest, for instance, the team establishes a view on different asset classes and investment styles to manage its range of target return funds. Today, the asset growth in asset allocation funds supports the proposition that strategic and tactical allocation to the best investment talents can generate superior risk-adjusted performance.

For the industry as a whole, being a winner requires first an understanding of the customers' needs and the competitive landscape in each segment of the servicing model (see figure two). Then it requires an ability to apply these insights to execution of their added value proposition. The balance of power between asset managers and multi-managers might be shifting in favour of the latter. But success for multi-managers depends on their skills in delivering efficient and effective investment to clients.

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