The Benefits, Misperceptions and Rationale for the Multi-Manager Approach

Northern Trust

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Introduction

In recent years, there have been a number of debates about the validity of using a multi-manager approach as an investment solution for institutional pension schemes. This chapter considers the rationale for using the multi-manager approach, some of the misconceptions and what the investor can reasonably expect.

What is multi-manager? Does a firm just pick a number of managers for a scheme, then revisit it after a few years to evaluate their decisions? What are the key characteristics? What should an institutional investor be prepared for? Why does it differ from other solutions such as a passive approach, an active single manager, fund of funds or hedge funds? What we are referring to here are long-only multi-manager solutions – that is, funds that combine together segregated accounts of external managers.

Ensuring best practice for pension funds

The role of UK pension fund trustees has come under a great deal more scrutiny in recent years – first, as a result of the Maxwell affair which brought about more protection for scheme beneficiaries, but also more focus on the responsibilities of pension fund trustees. Secondly, the Myners Review[1] has prompted trustees to revisit their investment approach to ensure that investment decision-making adheres to Myners' four 'guiding principles': that investor decision-making is most effective when it is conducted with appropriate skill and transparency, and is well-informed and debated.

Myners spoke about the 'wholly unrealistic demands' made of pension fund trustees, who are being asked to make crucial investment decisions but 'lack either the resources or expertise'. As such, they turn to investment consultants, of which Myners commented:

> 'a tiny group of providers, mainly actuarial firms, dominate this small and not particularly profitable market. The result, despite these firms' best efforts – to which I pay tribute – is a narrow range of expertise and little room for specialisation. Nor is the consulting firms' performance usually assessed or measured.'

To avoid this apparent blurring of roles, Myners clearly defined the specific tasks of the consultant for the following functions:

- asset–liability modelling;
- benchmark advice;
- recommendation of investment manager; and
- asset allocation.

Myners was very clear that the following functions required specialist skills that the trustee should ensure were being adequately resourced:

- selecting underlying expertise;
- fitting managers to benchmarks;
- monitoring adherence to guidelines;
- controlling style risk;
- hiring best-of-class specialists;
- hiring and replacing managers;
- alternative managers included; and
- measuring manager performance.

The Myners Review was fast becoming considered ‘best practice’. Although the review only offered ‘recommendations’, if trustees did not adhere to these principles and ensure the appropriate skill, care and due diligence, they were compelled by Myners to let the scheme members understand why. Whilst the principles of the Myners Review were not applied industry-wide, the review serves as a reminder and reference document to employ the appropriate skill sets that are expected to drive the industry towards best practice in the future.

Beleaguered trustees, most of whom were unpaid, were faced with more responsibility at a time (2001–03) when global equity markets were in the midst of their longest bear market in recent history. Some of these pension schemes were invested in balanced funds, regarded by many as lacking the required expertise and ‘best-in-class’ principles that Myners advocated. The underlying investors were asking about pension fund shortfalls and capital losses, mainly attributable to the plummeting bear market, and linking this with criticism of the pension schemes for which the trustees were accountable. The multi-manager approach offers an all-round solution to the Myners principles.

Conception of the industry and current trends

Long before Myners Review, the approach of multi-management was being developed. From the 1970s, US firms (Russell, Northern Trust, SEI) were developing research platforms and portfolio construction capabilities to provide multi-manager funds. The initial providers developed the platforms out of their consulting activities, but soon the multi-manager divisions were being spun out to form independent entities to avoid conflicts of interests. There was also a growing realisation that consulting and managing multi-manager funds were very distinct skill sets and business activities.

By the 1990s, the industry was well established in North America, South Africa and Australia. In Europe and most notably the United Kingdom, the industry was growing very quickly. Japan and the rest of Asia were slowly catching on, but only in 2005 did their industry appear to be growing at a significant pace.

A survey by research and consulting firm Cerulli Associates of asset growth from 2001 to 2003 showed that assets within multi-manager strategies had grown to US$680bn and that between 2002 and 2003 the rate of growth was 28 per cent. These multi-manager assets include retail manager of managers, institutional manager of managers and funds of funds. Specifically, the institutional manager-of-managers industry is estimated to account for US$114bn of this total, having grown 15 per cent from the previous year. In the previous four years, the industry had grown at 14 per cent compound annual growth rates (CAGR), significantly outstripping 3 per cent CAGR for mutual funds and 1 per cent for other professionally managed assets. Cerulli estimated that institutional manager of managers would continue to grow at 14 per cent CAGR through 2008 as the industry 'continues to benefit from long-term growth catalysts present in the industry', including increased outsourcing from key fund distributors and a growing demand for advice and due diligence within fund offerings, which offer good long-term performance potential.

The 'other' significant area of growth within the asset management industry during this time was in funds of hedge funds. Cerulli estimated that net new business in funds of hedge funds worldwide during 2003 was US$65bn, compared with an estimated US$66bn in multi-manager strategies. Funds of hedge funds certainly caught the headlines, in terms of their popularity, in part driven by the bear market in long-only equity markets.

Misperceptions

Some observers criticised the multi-manager approach during the bear market of 2001–03. They seemed frustrated that multi-manager programmes could go down when the market went down. They had hoped that this new approach of choosing niche specialists and continually researching the manager universe would generate not only outperformance of the index but also insulate them against market declines, despite them being 'long-only'. This is a false expectation, akin to comparing a fund of hedge fund performance with a runaway bull market in equities.

Long-only manager of managers are not absolute-return type vehicles. The products and regulatory environments by which they are governed compel them to be fully (90 per cent) invested and only allow limited use of hedging instruments – that is, for efficient portfolio management and risk reduction. They are not allowed to 'speculate' using derivatives. Some of the underlying managers within a multi-manager strategy can have an absolute return 'philosophy' – that is, they seek to avoid capital losses. They may do this by taking more significant off-benchmark positions or employ techniques that stop loss at a given level. They are still, however, subject to the same rules as the other long-only managers, and should be compared with a long-only index.

Underlying philosophy

What is the underlying philosophy of managers of managers? Five component parts can be identified:

- a belief in active management, the ability of talented individuals to use skill and knowledge to add value over an index or other benchmark;
- a belief that specialists will fare better than generalists in their particular area of expertise and that by finding and combining talented specialists, portfolios can be constructed which have an increased chance of success;

- a belief that style investing involves potentially unrewarded risk and that a better relationship between risk and return can be achieved by combining managers with different styles in any given asset class to create a style neutral portfolio;
- a belief that a skilled and diligent manager of managers can identify these specialists and combine them with sufficient skill to provide a risk controlled, diversified portfolio which should add value over the benchmark; and
- a belief that such a programme, and the managers within it, should be monitored on an ongoing basis, with changes made in a timely and efficient manner when the monitoring indicates a need for change – whether this be a change of manager or a change of balance between managers.

In applying this philosophy, different managers of managers will emphasise different aspects – the importance of people as opposed to organisations, for example, or the optimal number of managers in an asset class.

Managers will be appointed to run assets for the manager of managers on a separate account basis and the details of the mandate, the guidelines and restrictions, will be agreed between the manager and the manager of managers. Transitions between managers will typically be handled by a transition specialist.

In summary, managers of managers conduct research to seek out the specialists who they believe will add value over the index. When they are combined together with other uncorrelated specialists, this offers a compelling long-term investment vehicle. Implicitly multi-managers do not believe in indexation, as the belief is that the intelligent use of specialist active managers will add value over the long term. This is not to say that there is no place for passive management – it does have a role, the extent of which will depend on investor attitude to risk and return.

What does a multi-manager seek to achieve?

The investment objective for most multi-manager vehicles is 1.5 to 3 per cent per annum gross of fees. If the markets remained flat and the multi-managers achieved their target over a 40-year contribution period, the result would be a pension fund between 81 per cent (that is, 1.5 per cent per annum) and 226 per cent (3 per cent per annum) larger than the indexed pension fund. These results are gross of fees, which will be discussed later.

How should we use the index? We can certainly use it as a gauge of performance. Fund management is a competitive industry that relies on insightful and intelligent decisions. Relative out/underperformance (fund versus index) tells us that good/bad decisions were made. Performance attribution highlights more specifically areas of strength/weakness in the portfolio versus the index. We also know that the index represents the investible universe, so we can compare portfolios for style and exposure comparison. However, it should not be regarded as the 'risk-free' solution.

Although tracking errors can be misleading, the index can provide useful gauges of risk. The risk measure that provides the best gauge of the risk taken to generate performance is the information ratio. The information ratio effectively gives a measure of the effectiveness of decisions of the fund given its deviation from the index. A fund with superior information will achieve higher information ratios. Multi-managers employ specialists, therefore they would be expected to have higher long-term information ratios. The higher information ratios are one of the key benefits of the multi-manager approach.

Where are the specialists found?

One type of manager generally avoided is one that uses the index as the basis for decision-making. Some active managers also use tracking error as a measure of risk, believing that lower is better. Moreover, some fund managers are mindful of this generally accepted perception of risk and run portfolios with the objective to minimise it.

Investment processes and portfolios that hug the index tend to be a higher cost alternative to a passive approach. Investment decisions that are based around incremental positions around the index are inevitably hindered by the same market weaknesses that afflict the index trackers – that is, an inherent bias to larger stocks. Of course, the lower business risk associated with being closer to the benchmark is also compelling.

Aware of this business risk, during the 1980s and 1990s a number of firms established very profitable fund management companies, charging active fees and delivering index +/-1 per cent. They became industry behemoths, sometimes swallowed up by large investment banks eager to capitalise on the significant profit margins and a 'stable' revenue stream. The business models were scalable: they could grow their assets under management, with very little incremental cost. These business models were driven by asset gathering rather than quality products. Perhaps five times as much was spent on asset gathering than actually managing the money. Sales were viewed as revenue generating; fund management viewed as a cost that should be minimised.

Boutique investment managers

The formation of boutique investment managers provided some solution to this, offering specialisation as the larger firms were, by now, cutting fees to maintain sales growth. The boutiques were attractive to the multi-managers: they were highly incentivised by ownership and performance criteria. They were also small and nimble, without the bureaucracy of a larger organisation. Some of the banks responded by establishing specialist skills within their organisation, highly incentivising their key people and providing them with the resources that enabled them to fully implement their investment process.

The industry now has specialist capabilities. The boutiques, with small marketing budgets will likely be perpetually small, nimble, focused and generally happy places to work. The large houses will continue to grow, but as long as senior management does not interfere too much, they will provide some competition to the boutiques. Increasing size inevitably produces spin-offs – portfolio managers who want to control their own destiny. Managers of managers will generally prefer the boutiques but the bigger firms are no longer excluded.

What to look for in a specialist

Once a specialist active manager has been identified the investment process, its people are then appraised. The investment process can be grouped into one of the major style buckets: aggressive growth, growth, GARP (growth at reasonable price), core, flexible, value or deep value. There are a number of other less commonly used processes, including relative value, sector neutral, momentum, thematic, top-down and quality.

The purpose of the multi-manager fund is to combine uncorrelated specialists. Therefore, knowing one manager's area of specialisation allows this manager to be combined with a complementary style manager – for example, an aggressive growth manager could complement a deep value manager. Balancing growth and value is probably the most common combination used by multi-managers; but there are a number of others, such as balancing market *cap bias,* momentum and rotation. By doing this, style risk – for example, growth and value – would be neutralised. The aggressive growth manager would be expected to outperform during a growth rally but also be specialist enough not to implode when growth falls out of favour. The deep value specialist may underperform during the growth rally but perform strongly in a value cycle. Over a full cycle of value and growth, which may be five years, both managers would be expected to outperform and the multi-manager to have achieved their long-term investment objective.

The advent of style risk has become very evident as some market followers saw highly unstable return patterns if they chased the growth cycle at the end of 1999 and then the value cycle in 2001 to 2003. Being 'style neutral' is another perceived benefit of the multi-manager approach over other investment vehicles. The investor is able to avoid style-driven underperformance, which often capitulates at exactly the point at which the market reverts, causing the underperformance to continue.

Mercer Investment Consulting described the differing styles of value and growth as follows:

> 'In a nutshell, value managers believe that stocks which are "cheap" will outperform over the long term. The "cheapness" of a stock can be based on its current price relative to one or more of a number of valuation measures such as historic or near term earnings, cash flow generation, or tangible asset valuations ...
>
> 'In general, growth managers believe that growth in earnings drives stock returns and that success requires the identification of stocks with an ability to deliver such growth over time.'

Mercer goes on to examine whether a portfolio should be tilted towards value or growth:

> 'Our databases show that returns delivered by value and growth managers have been similar over the long term (15 years to June 2004). However, there is some evidence that value managers can deliver lower volatility than growth managers. Accordingly, for investors for whom absolute risk is important, there may be a case for tilting towards value provided that the additional risk relative to the broad market benchmark is acceptable.'

On whether being style neutral reduces potential return, Mercer concludes:

> 'A style neutral approach to portfolio construction does not necessarily mean a reduction in the potential return. Rather, it means that the return is being sought from stock selection. All other being equal, this should lead to more reliable outcomes.'

How a manager uses quantitative and qualitative analysis

There are a number of ways a multi-manager appraises style quantitatively. The first major technique is to look at the returns that have been generated historically and compare these with the style indices. If the returns are more highly correlated with the value index than the growth index, this suggests a value approach. The second and more accurate way to evaluate style quantitatively is to consider the holdings of the underlying portfolio and look at the fundamental factors versus the index. A weighted average computation of the portfolio's fundamental factors (price/earnings (P/E), price/book, yield, EBITDA, beta and so on) can then be compared with the index. If the portfolio has a significantly higher P/E and lower yield, for example, we can ascertain that the portfolio has growth characteristics. In order to avoid style drift or a market-oriented approach, the holdings should be analysed historically. Looking at quarterly data over say the last 12 quarter end periods will provide data on how much the portfolio moves around the style spectrum.

When constructing the portfolio, the multi-manager needs to be aware of style compatibility between the selected managers, but also needs to be constructing portfolios with effective diversification. The eventual number of stocks may be too high in the eventual portfolio to achieve the investment objective. Therefore, multi-managers tend to use concentrated portfolios – maybe 30 to 45 stocks which, when combined together with other concentrated portfolios, maintain sufficient active risk. A three-manager structure would then have about 100 stocks, each of which has been selected by a specialist, providing the multi-manager fund with effective and specialist diversification – another perceived benefit of the approach over its competitors.

Portfolio construction is a key part of the multi-manager process, a process that has the following objectives:

- effectively diversify;
- retain appropriate active risk;
- monitor and rebalance to neutralise style risk; and
- continually ensure that best-of-breed managers are used within the funds.

The quantitative analysis provides the data that supports these decisions including appointment or deselection of a manager.

Throughout this quantitative analysis it is always important to incorporate the qualitative research, since a track record may be attributable to a previous colleague or the process may have been changed by a new Chief Investment Officer (CIO). Qualitative analysis is very important to a multi-manager, who often spends hours at the desks of fund managers figuring out how their models work, how they prepare for company meetings, and generally how they work on a day-to-day basis. When appraising a fund management organisation, it is essential to meet the people who are actually managing the money: it is very easy to get the big corporate welcome and be impressed by the marketing team.

Due diligence

Due diligence is integral to the multi-manager process. Aside from 'kicking the tyres' on appointment, due diligence also involves regular reviews, compliance and investment monitoring of the portfolio and making timely decisions in response to day-to-day issues. Pension fund trustees typically do not have all of this information at their disposal: they may meet infrequently (perhaps once a quarter) and, especially considering the mounting regulatory work they complete, may not have sufficient time or ability to make the appropriate decisions. Pension fund committee structures must ensure they have the appropriate debating forums that lead to effective decision-making, as inaction on behalf of the committee is an active investment decision.

Choosing a multi-manager

There are significant differences in multi-manager fund providers: some use more managers than others; some prefer only quantitative techniques; others prefer to use large organisations within their funds or firms with at least a three-year track record. These are all very real differences that can have a significant bearing on the eventual success of the strategy. As with any investment, '*caveat emptor*': understand the differences between the manager of managers and seek advice on the relative strengths and weaknesses of the organisations. If a consultant is recommending a multi-manager, an insight into the competing firms' abilities needs to be displayed and as a result be able to advise pension fund trustees accordingly.

Multi-manager funds are not the exclusive domain of the institutional market. Indeed, given their popularity in the institutional arena and the associated low costs, retail providers have been quick to seize on the opportunity. They are attracted to the multi-manager fund for a number of reasons. First, it is a lower cost model to a fund of funds, where the underlying managers charge retail-type fees. Secondly, it opens up a completely new universe of managers who do not have retail funds. This universe includes managers who have historically sought only institutional (that is, large) accounts. Many of these firms are niche, boutique specialists who have neither the infrastructure nor the marketing machines to compete with the large retail houses. Third, manager-of-manager funds offer transparency and control since the underlying manager accounts are segregated.

The mainstream manager-of-managers providers do not use internal fund management products – that is, funds that are part of the same organisation. This helps to ensure objectivity in manager selection/deselection. No matter how good an internal fund is, most have an absolute rule that prevents use of internal capabilities.

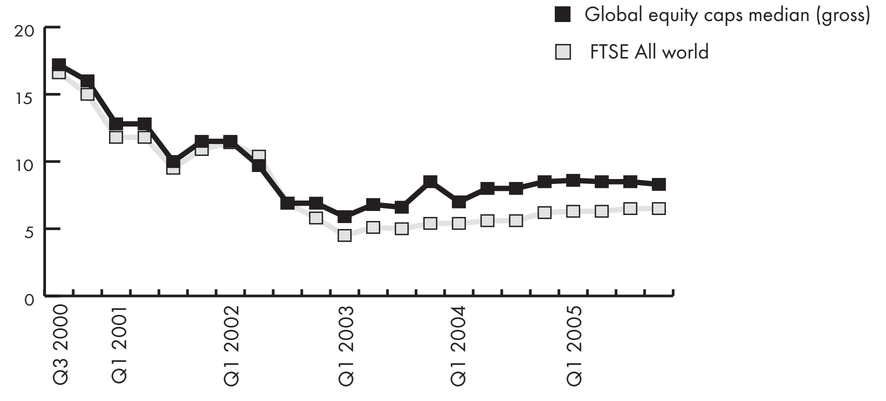
Fees

Active managers charge fees that are higher than passive providers. Fees are often cited as one rationale why active management should not be pursued. During short-term periods of underperformance of an index, trustees question why they should pay higher fees when the lower-cost alternative (that is, passive) is performing just as well. Yet sustained periods of passive approaches outperforming specialists are rare. For example, in the 22 quarterly rolling three year periods since July 2000 the median UK equity manager in the Russell MellonCAPS survey has beaten the index 18 times, while for Global Equities the figure is 20 out of 22 periods – and this is just the median manager (see Exhibit 1).

Some active managers charge much higher fee levels than others, and again the higher charge can offer no absolute guarantees of success. Fees sometimes reach in excess of 100bp

Exhibit 1

Rolling ten years performance of passive versus specialist investments



Source: Author's own

as a flat fee if a pension fund chooses to go direct to an active manager. Within the institutional arena, fees are normally not quoted this high although institutions that do not negotiate effectively can end up paying considerably higher than others.

Performance fees are often an added incentive, but the key advantage of a performance fee is that the interests are aligned with the pension fund beneficiaries.

Fee levels that are given to the underlying managers should reward them for the specialist skill set they possess, their ability to add value, and an appreciation of the real costs in running and administering a segregated portfolio. The fees should compensate the people making the investment decisions with appropriate incentive structures to allow the firm to attract, retain and motivate key individuals. Ultimately, they need to add value, although this should always be viewed with a long-term perspective.

The fee levels paid should encompass 90 per cent of the available universe of underlying managers. This will amply allow the search for any new manager to be sufficiently wide – therefore the fee negotiating needs to be appropriate to avoid exclusion of an appropriate strategy.

Multi-managers negotiate lower fees than can normally be negotiated by the institutional investor, because they represent a number of pension funds, which, crucially for the underlying manager, cuts out the costs of growing accounts – that is, marketing and client service for the underlying manager. When the final fee structure is viewed (for example, 60bp for UK equities, which includes all the underlying managers' fees and the manager-of-manager fees), the accusation that employing a manager of managers involves an additional layer of fees seems unfounded. When other aspects of the role are taken into account, such as ongoing monitoring, due diligence, effective decision-making and so on, the multi-manager approach can become a compelling value proposition from an outsourcing perspective.

Expectation of performance?

Ultimately, managers of managers will be dependent on their success. Whilst they would be expected to have superior information ratios as discussed earlier, what kind of performance can the institutional investor reasonably expect? It would be reasonable to expect that over long-term time periods the manager of managers should achieve its investment objective of 1.5 to 3 per cent relative outperformance over rolling three- to five-year periods, which is a very attractive proposition from performance and risk perspectives.

Will multi-managers perform in all market conditions?

Managers of managers should perform well over market cycles which will typically include both growth and value led periods. Additionally, they should do well when quality is rewarded in periods of high volatility, bull markets, bear markets and so on. However, there are very distinct market conditions in which managers of managers can reasonably be expected to underperform. The first is during narrow markets when the indices are driven up by one or two sectors. Being more effectively diversified would likely mean that the multi-manager is not concentrated in these sector/s and would not participate fully in this scenario. The second condition is a low-quality rally. Typically, managers of managers seek out quality fund management companies who, because of their search to find similarly quality companies, avoid lowly rated, high beta types of stocks. This occurred in the second and third quarters of 2003, when low-rated, small cap, high beta stocks strongly outperformed. Finally managers of managers will underperform those managers whose style is in favour during a trading market. However, these market scenarios tend to be short-lived; markets will revert to normalised conditions and the long-term relative outperformance should perpetuate.

It is important that the managers of managers have this long-term perspective: to assess managers based on the sustainability and repeatability of the investment personnel and process. All too often, investors make decisions based on recent performance, which is notoriously a weak lead indicator of future performance.

Summary

The process for multi-managers, as described earlier, relies on an evaluation of people, the process and the underlying portfolio to see not only if it is the best in class, but also whether it fits in the overall strategy.

The processes in place at the manager of managers also need to be robust. Importantly, it is a dynamic process that requires continued research of the available manager universe and significant investment into people and systems to ensure that the manager selection and portfolio monitoring remain appropriate.

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[1] In March 2000, the Chancellor of the Exchequer commissioned Paul Myners to conduct a review of institutional investment in the United Kingdom. Myners concluded that there were a number of areas where change would result in improved investment decision-making. In his report, which was published in March 2001, he recommended that pension fund trustees voluntarily adopt, on a 'comply or explain' basis, a series of principles codifying best practice for investment decision-making. See HM Treasury website at www.hm-treasury.gov.uk under financial services, securities and investments.

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Northern Trust is a pioneer of manager of manager investing and believes in the importance of portfolio diversification and understanding and managing risk expectations. The combination of asset classes, allocation and investment styles in one fund, leads to greater diversification at all levels. Our product offering is highly customised, offering a complete investment management programme whilst incorporating a wide range of funds.

Please call us for more information or visit northerntrust.com

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