THE COST-EFFECTIVENESS of multi-manager funds

Multi-manager funds, long thought of as expensive, can cost investors less, while providing numerous benefits.

Financial advisers often think of multi-manager funds as a hard sell to investors because of perceived higher costs. However, in reality, investors could be missing out on one of the best kept secrets of successful long-term investing.

Blurry confusion

Confusion about the fees charged by fund of funds and those of multi-managers tends to blur the issue. Fund of funds are very expensive, partly because these managers do not have the necessary scale to negotiate better fees.

Multi-managers, on the other hand, benefit from having significant scale, allowing them to negotiate cost-effective fees. As such, multi-manager funds charge far less than fund of funds, and are often even more cost-effective than single manager funds.

Blending managers in a portfolio

A multi-manager is a fund manager that creates a portfolio by choosing multiple managers to manage the underlying mandates. The aim is to diversify risk and the potential returns through blending some of the best managers in a particular portfolio. By their very nature multi-manager funds have an additional layer of fees (the fee they charge for their service and the fee paid to the underlying asset managers).

This does not necessarily translate into a higher overall fee or total expense ratio. This is because large multi-managers can negotiate very competitive institutional fees with the underlying asset managers, more than offsetting the fee they add on for their service.

A single manager, for example, might charge 1% for their fully discretionary balanced fund, while a multi-manager with a R5 billion fund may access the same mandate for 0.7%. If the multi-manager added a fee of 0.25% for their services, the total charge would be 0.95% cheaper than the single manager.

Added to this, the investor gets all the benefits offered by multi-managers.

Multi-managers conduct extensive research on the investment industry to understand the landscape and the players. They spend huge resources on understanding these managers through an investment due diligence process that covers the managers' investment philosophy and process in detail. This covers house factors, people and teams (including how they are incentivised), and the principles and policies they subscribe to.

Multi-managers decide how to weigh each mandate (from their buy list of managers researched) within the overall fund. A large multi-manager's sizeable investment team and the quality of its people, processes and systems means that its research and on-going monitoring is rigorous and robust.

Due diligence matters

Having a multi-manager investment team responsible for investment due diligence is like having a professional on your side who knows what to look for and knows how to decipher complex financial language. A multi-manager, by constantly reviewing a fund's investment positions and mandate adherence, aims to identify and prevent catastrophic risks before they occur.

There have been a number of high-profile fund failures which bring to the fore the importance of operational and governance due diligence. The 2008 Fidentia scandal saw R1.4 billion siphoned from a pension fund aimed at paying an income to widows and orphans of mineworkers. In 2013, the Sharemax-promoted Zambezi Retail Park property syndication turned out to be a Ponzi scheme with R2.5 billion of investors' capital disappearing.

As recently as December, a South African unit trust lost 66% of its value in two days when the fund manager could not get out of complex derivative positions that went against it following President Jacob Zuma's shock firing of Finance Minister Nhlanhla Nene. In total, investors lost more than R250 million.

The lesson is clear. Operational due diligence and governance procedures matter. Changes in regulations are raising questions about the manager's risk governance and attention is shifting to the administrator and trustee. In cases like these, financial advisers could be next to come under the magnifying glass, especially if the work that they have performed before recommending a fund to a client is superficial, baseless, or based on past performance.

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