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Investing with a coach

How multi-managers guide investors to success

The best international cricket teams have a balanced mix of quality batsmen who score at a slower defensive pace but accumulate lots of runs, and some hard hitters who can quickly score 50 runs towards the end of an innings. Having the combination and versatility of skills and understanding which type of player will perform in changing match conditions is what creates a world class team. This is the essence of good multi-manager funds.

At STANLIB Multi-Manager we strive to be what a coach is to a cricket team. We look for different combinations of skill, philosophy and process to blend into one fund. Think of it as understanding factors like the condition of the pitch, the bowler's pace, the light and ball visibility on any given day and having the correct combination of players to perform regardless of the conditions.

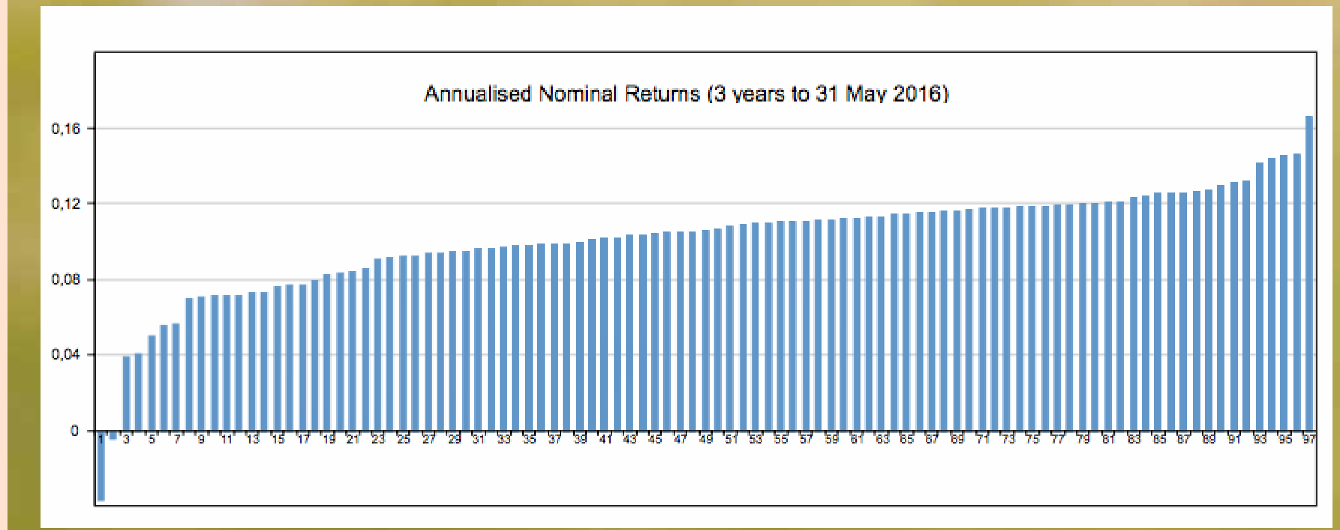
Not dissimilar to international cricket, diversification is important for investment success. Good multi-managers not only understand the importance of diversification, they also understand how to use it to maximum effect to generate higher risk-adjusted returns.

Diversification

Simplistically, a multi-manager fund can provide up to three levels of diversification, namely diversification across managers by allocating to more than one single manager, diversification across asset classes, and diversification across instruments.

Managers may construct portfolios to have exposure to many different risk factors

An investor in a single manager fund will typically achieve diversification in only two of these areas: asset classes and instruments. Diversification among managers and not selecting only one manager reduces the impact of selecting a poor performing manager. The graph below of fund returns over three years for the ASISA South African Multi-Asset High Equity category illustrates our point.



Not all investment philosophies and processes perform well all the time. As can be seen in the below graph, one fund had a negative return of almost 4% over the last three years, while the top performing fund returned over 16% annualised. This is a 20% per annum difference in annualised returns from funds trying to achieve a similar long-term objective (or 76% cumulative – almost double).

An economy moves in cycles. For a period of time interest rates may be rising, followed by a period of low interest rates. Inflation may be pushing higher or it may be under control. Commodity prices could be in a strengthening cycle or in a period of prolonged weakness. Exchange rates could also be volatile. The macro-economic environment is just one aspect managers consider when constructing their portfolios.

Even though there could be an overlap in parts of managers' investment philosophy and process, every manager is unique (with different people, specific assumptions in their different models, teams with diverse backgrounds and different processes). While some single managers employ forward looking strategies, such as estimating future cash flows, others focus more on historical information, such as historical price earnings ratios.

Managers may construct portfolios to have exposure to many different risk factors. They could be rand or interest rate sensitive or focus on defensive companies with stable earnings (quality). They could follow a growth philosophy, a value bias, or a momentum bias chasing past winners higher until the bubble pops. Others go where they think they can buy instruments below their intrinsic value and have no specific style bias. These factors play a critical role in driving a manager's performance.

In the context of changing economic cycles or changing market conditions, it is important to understand which blend of managers has the best chance of outperforming through the cycle while not taking excessive risk. This is where the role of multi-managers becomes critical. We blend managers to achieve the combination that we think will outperform over the medium- to long-term.

We determine diversity through a number of different measures, including correlation, which measures the strength of the relationship between two assets. We are interested in the correlation (or relationship) of returns between different managers in a portfolio as we don't want managers that are highly correlated i.e. underperform at the same time, as this would limit diversification. When constructing a fund, we are typically looking for managers who improve diversification to achieve a balance between risk and return.

Correlations are however a pretty blunt tool in understanding the differences between managers, so we employ a range of additional advanced statistical techniques to understand this complex dynamic.

Often investors choose single managers based on their record of past performance. A manager's past performance may have benefited from a specific economic environment, such as a depreciating rand. Investors often do not consider how the manager will perform in the long-run, through various changing economic environments. The problem with this approach is that a manager will go on to underperform, and investors will not understand why, so they disinvest. The manager then goes on to outperform again, and investors lose out by continually switching out of great managers to chase the managers at the top of the latest ranking tables.

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STANLIB Multi-Manager builds portfolios that will deliver great risk-adjusted returns over the long-term, through various business cycles. This is achieved by selecting and blending managers based on rigorous qualitative and quantitative analysis of the managers across many dimensions that are important in determining future performance. These managers are monitored on an on-going basis to ensure that they continue to meet the client or portfolio's investment objective. We don't do this in isolation, but in combination with all the other managers we have selected. Whether it's international cricket or financial markets, understanding the playing field and picking the right combination of players has been shown to deliver superior results.