



Insight Report

Multi-Manager Guide

What is Multi-Manager?



adviser.defaqto.com

Recent reports by Defaqto:

Pet Insurance in the UK 2008	Pet insurance is for life, not just when you can afford it	Dec 2008
Blending Talents 9	A Free Guide to Multi Manager Investing	Nov 2008
Retirement Savings and Income		Nov 2008
Motor Insurance 2008	Difficult Times Ahead	Sep 2008
Current Accounts 2008	All Change	Sep 2008
Income Protection Insurance	Nobody's Child	Aug 2008
UK Home Insurance	Aggregation or aggravation?	June 2008
Offshore Bonds 2008	Calmer Waters	June 2008
Critical Illness 2008	A critical time for critical decisions	June 2008
Equity Release	Entering the mainstream	May 2008
UK Motor Aggregators 2008	Still much to do	May 2008
Travel Insurance	Adapting to a Changing World	May 2008
SIPPs in the UK 2008	The Personal Pension of the Future	Apr 08
Stand and Deliver	Adviser Platforms in the UK	March 2008
Payment Protection Insurance 2008	The Party's Over	Feb 2008
Pet Insurance in the UK	Bark worse than its bite,	Dec 2007
UK Unit Linked Bonds	Stick, twist or bust?	Dec 2007
Credit Cards in the UK	Inventing charges	Nov 2007

Table of Contents

Recent reports by Defaqto:.....	1
Table of Contents	2
1. Introduction.....	3
2. Multi-manager: the different structures and what they mean	5
2.1 Manager of Managers (MoM)	5
2.1.1 MoM structure advantages	5
2.1.2 MoM points to consider	5
2.2 Fund of Funds (FoF)	6
2.2.1 FoF: fettered or unfettered.....	6
2.2.2 FoF benefits.....	6
2.2.3 FoF points to consider	6
2.3 Hybrid	6
2.4 Regulation	7
2.4.1 Fund structures.....	7
2.4.2 Multi-asset investing	8
3. Multi-manager benefits: what they seek to bring	9
4. The multi-manager investment process.....	10
5. Outsourcing investment: insourcing relationship building	11
6. Fund availability	12
7. Freedom means responsibilities investment responsibilities	13
The Author.....	14
Fraser Donaldson	14
Principal Consultant.....	14
– Investments	14
Career to date.....	14
Responsibilities.....	14
Specialisations.....	14

1. Introduction

The adviser community continues to see multi-manager investing as a valid way to outsource the management of client portfolios. The range and structure of funds is such that advisers can now choose to what level they need to outsource.

The multi-manager industry has gone from strength to strength over the last few years and has become a must have option for investment based tax-wrappers.

So popular has multi-manager investing been, that the regulators have in the past expressed some concerns that the adviser community may not necessarily understand fully the implications of selecting these funds

This guide is designed to deepen your appreciation of the different ways in which multi-manager funds are managed and to give you increased confidence that you are choosing an investment medium that is appropriate to your clients.

As ever, we are very keen to hear feedback from our readers, so if you have any comments or questions please feel free to contact me:

Fraser Donaldson, Principal Consultant – Investments
fdonaldson@defaqto.com

2. Multi-manager: the different structures and what they mean

There are three types of multi-manager:

- Manager of Managers
- Fund of Funds – fettered and unfettered
- Hybrid

2.1 Manager of Managers (MoM)

Managers of managers appoint under managers (sub-advisers) for their expertise in an asset class or sector, to run individual parts of the portfolio as segregated mandates. The segregated mandates give the manager of managers greater control over the portfolio and over costs. The manager of managers will stipulate parameters such as geography (e.g. Japan), capitalisation of the underlying stocks (e.g. large cap), a risk budget, and the benchmark against which the sub-adviser must perform. The manager of managers is employing the sub-adviser to select the underlying stocks, and may monitor them at the transactional level.

- Managers of managers are responsible for designing the overall structure of the fund; for researching and identifying top-performing fund managers to run the mandates; for managing them and for ensuring that they blend together.
- Because of the large sums of money that may be involved, managers of managers have access to sub-advisers who may not normally be accessible or familiar to retail investors. They can be fund managers, institutional or retail, selected from anywhere in the world.
- Use of institutional sub-advisers by the manager of managers can be cheaper than using the retail funds employed by their fund of funds counterparts, keeping costs relatively low.
- As the management of the individual mandates is subject to a formal agreement there is often a notice period required for replacing a manager, typically several weeks. In practice, however, sub-advisers will often relinquish their portfolios immediately in the hope that the manager of managers will consider them again in the future.
- When a manager of managers decides to replace a sub-adviser, transaction costs are kept to a minimum as the new manager starts with the invested segregated portfolio and may not need to change all of it.

2.1.1 MoM structure advantages

- The manager of managers can define precisely how they want the various segments of the portfolio to be managed rather than buying into a fund that provides a best, though not perfect fit.
- As the under-managers are generally paid from the overall fund annual management charge, there is a reduced scope for double charging.
- Portfolio monitoring can take place on a real time basis rather than after the event. This allows, especially in fast or volatile conditions, a manager of managers to ensure that the sub funds and the overall fund structure - reflecting the actions of all the sub-advisers - is appropriate in terms of risk and return expectations.

2.1.2 MoM points to consider

- If recently launched or if the manager of managers fund has attracted insufficient subscription, it may not be large enough for them to engage their under-managers of first choice, even after seeding by the MoM company.

- It is likely that many of the sub-advisers will be unknown to you with little press comment available. This may be important to you if you like to monitor multi-managers closely. Fund of funds managers will be purchasing publicly available funds.

2.2 Fund of Funds (FoF)

The FoF manager invests the portfolio into other collective funds regulated as UK authorised collective investment schemes and often offshore funds.

A FoF manager is concerned, principally, with fund manager selection, monitoring and portfolio construction rather than with the make up of the fund at stock level. In particular they are concerned with monitoring how managers perform in particular market conditions and how the selected funds blend together.

- Because of the large sums of money that may be involved, the FoF manager is able to obtain access to institutional funds that may otherwise be denied to the retail investor.
- The FoF manager keeps the portfolio aligned with their view of the market, monitoring the under-managers and changing them when necessary.
- The FoF manager will utilise their buying power to negotiate favourable rates on investment into the underlying funds.
- Transactional costs may be higher than their MoM counterparts as a change of manager means a change of sub-fund rather than changing a smaller number of individual stocks. For this reason portfolio turnover may also be higher.

2.2.1 FoF: fettered or unfettered

Funds of funds are either fettered or unfettered. Fettered funds of funds invest in funds managed by the same fund management group as the FoF manager. Unfettered fund of funds may invest in any fund and fund management group they choose. Unfettered funds argue that they achieve a much wider degree of diversification, while fettered funds claim lower costs and reduced elements of double charging.

2.2.2 FoF benefits

- The concept offers the investor a wide range of diversification in one fund and access to some of the best fund manager talent around.

2.2.3 FoF points to consider

- Changing funds is not a case of changing managers. Funds will have to be sold, cash raised, and then reinvested into the new fund. Transactional costs are likely to be higher than their MoM counterparts.
- Total Expense Ratios tend to be higher as an inevitable consequence of investing in retail funds which themselves carry a cost load. This is not a show stopper where returns are high but in an area where returns are less rewarding and where fund homogeneity is high (for example UK bonds and especially gilts) the extra costs can be a barrier to relative performance.

2.3 Hybrid

Hybrid funds are a mix of the two main approaches, MoM and FoF, and so may hold both collective funds and segregated investments. For example, where the manager is unable to find a fund to meet precise investment requirements, the hybrid manager may engage a manager to run a segregated mandate as part of the portfolio.

These structures are relatively new but in time will probably come to dominate the sector as there are circumstances where both MoM and FoF can benefit from exposure to the other methodology. For FoF, institutional scale investment can be cheaper via a direct MoM style portfolio; For MoM, purchasing a fund can be an advantage where the available asset pool is not enough to get diversified exposure to a specialist area or where the scale of investment required is so large that the only sensible approach is to buy into an existing structure.

2.4 Regulation

2.4.1 Fund structures

In addition to the different fund structures, the multi-manager can opt to be governed by differing sets of rules. Funds can come under either Undertakings for the Collective Investment of Transferable Securities III (UCITS) rules or Non-UCITS Retail Schemes (NURS) rules. NURS funds are deemed by the Financial Services Authority to be suitable for retail investors, but do not meet the more prescriptive rules of the European UCITS directive. Both of these offer the multi-manager more flexibility than previous regulations, enabling them to adopt more flexible approaches to risk and asset allocation. The following table shows the distinction between the two sets of rules:

Investment Powers		
Fund Attributes	UCITS III	Non-UCITS (NURS)
Assets	<ul style="list-style-type: none"> Transferable Securities Deposits Derivatives Money Market Instruments Other Collective Investment Schemes (CIS) 	<ul style="list-style-type: none"> Transferable Securities Deposits Derivatives Money Market Instruments Other Collective Investment Schemes Commodities Property Non UCITS Collective Schemes
Spread of Risk	<ul style="list-style-type: none"> Unapproved schemes 10% Unregulated CIS 0% Commodities 0% Any one CIS 20% Trackers 20-35% 	<ul style="list-style-type: none"> Unapproved schemes 20% Unregulated CIS 20% in aggregate Commodities 20% in aggregate Any one CIS 35% Trackers 20-35%

Table 1 – Investment Powers

Defaqto Analysis:

Performance has been far more dependent on investment objective than on the type of structure chosen.

2.4.2 Multi-asset investing

The changes in regulation leading to more flexible fund structures have added to multi-managers' armoury in the fight to preserve capital.

Alternative investments have become a preferred form of diversification among ultra-high net worth and very-high net worth clients, to the extent that, at these levels, they are now regarded as mainstream.

You would be forgiven for thinking that there are difficulties in trying to break into these high net worth plus strata, where clients are looking for a high level of investment sophistication. Some fairly profound expertise around alternative assets; their return, volatility and correlation are required. There is an increasing number of multi-managed, multi-asset offerings, however, providing high net worth and smaller clients with the opportunities to invest in these areas.

The advent of new UCITS III/NURS rules has enabled single and multi-manager fund managers to participate in the alternatives game, expanding the variety of asset classes that they can include in their portfolios, with potentially beneficial effects on their risk/return ratios.

Alternative investments: structured products; private equity; commodities; property, and hedge funds, are less correlated with stock market performance than traditional asset classes and have helped multi-asset funds post some attractive performance figures combined with volatility numbers associated more usually with less aggressive funds.

While the identity of these funds using the statistics is not immediately apparent, funds posting positive numbers in the 'Property %' and 'Other %' columns in the Statistics (part one) are likely to be adopting a multi-asset approach and may merit a further look.

However Fund managers may not have the skills to deploy their new tools. As the new diversification powers are being utilised to enhance the fund manager's effective use of risk you should also check the 'Information ratio quartile ranking' column which ranks funds' effective use of risk according to how much alpha they achieve per unit of tracking error, and then take a look at how consistent their performance ranking has been. You will see that the use of alternatives has produced some good results from a number of well known houses.

Alternatives are now main-stream and are available for your clients if appropriate.

3. Multi-manager benefits: what they seek to bring

Multi-managers build portfolios which at all stages of the economic and market cycle comprise fund managers whose investment style, consistency, and past performance demonstrate above average skill at that point in the cycle. Multi-managers argue that their portfolios are blended in such a way that success will be demonstrated through all phases of the economic and market cycle.

In purchasing multi-manager funds for your clients, you are employing teams of investment specialists, often using state of the art technology, who look to ensure that your clients' funds are continually monitored and appropriately diversified, with all the compliance benefits that this brings.

- Even a single multi-manager fund can bring a high degree of diversification.
- The expertise, specialisation and resource available to most multi-managers enables them to research a far greater number of under-managers and in far greater depth, than can the majority of financial advisers.
- The multi-managers will monitor and research the universe of funds and fund managers for new opportunities and potential replacements.
- The potential weight of money that a multi-manager may have to allocate to underlying funds and managers will give them access to a far wider manager universe than would normally be available to individual investors and financial advisers.
- A multi-manager will construct the underlying portfolio based on their investment philosophy arising from their view of the economic and market cycle. The multi-manager's investment philosophy may involve taking positions on style, asset allocation, cap size or even stock selection. The more strategic multi-managers will tend to go for neutral positions, hugging a benchmark or taking minor positions around it.
- The underlying funds and managers will be combined or blended to minimise correlation and risk. The investment philosophy will vary from manager to manager, and will be reflected in the fund statistics. An understanding of which approach a multi-manager uses is essential to choosing appropriate funds for your client.

Defaqto Analysis:

A client portfolio comprising a smaller number of multi-manager funds than a portfolio comprising a larger number of single funds may involve slightly higher management fees. The benefits bought are likely to be greater diversification, better monitoring, more rigorous research, reduced compliance and administrative simplicity.

The bonus? A greater proportion of your time spent with your clients.

4. The multi-manager investment process

Here we take a look at what multi-managers do to deliver performance. Only managers who follow this process rigorously make it to the top ranks and sustain this success. In recent years fund management groups have made much of the importance of meeting managers: a resource expensive task. The extent to which your own investment research programme falls short of the following investment research process may determine your interest in multi-manager.

1. Review of the general investment climate: Managers monitor and review the global economic and political climate, seeking to identify potentially big themes and trends in the world and how and where they can benefit from them.
2. Decide an appropriate asset allocation: The multi-manager will then consider the extent to which these global themes and trends have been discounted already by markets and where there may be pricing anomalies to be exploited. Their view will suggest an appropriate asset allocation which may be categorised in a number of ways: asset class; country; industry/sector; style.
3. Determine the style or trend that is in the ascendancy and select the fund managers that are likely to perform well in this environment: the fundamental work of the multi-managers is in identifying fund managers and working out, using returns based analysis, who out-performs and in which conditions they are most likely to do this.
4. Manager meeting programme: This work is supported by a rigorous manager research programme where the multi-managers will review the funds' performance data, send fund managers questionnaires, review the questionnaires and meet the managers. These structured meetings are designed to identify changes of practice, style, and some of the softer issues such as the adoption of a more house-based investment approach or office moves, that may render a fund manager unable to work in their accustomed way.
5. Seek out up and coming talent: Besides monitoring their current fund managers the multi-managers will be constantly looking to identify up and coming talent by reviewing performance statistics and meeting potential managers.
6. Monitor the resulting portfolios on a daily basis: Multi-managers review their under-managers for who is doing well or not and establish why. They monitor whether the fund managers are doing what they say they will do. They assess whether the economic and market cycle is moving from one phase to another and whether the proportions invested, within the fund, need to be adjusted to reflect this. The skill is to invest in the fund at the right point; take profits at the right point and to assess whether an under-manager's poor performance represents a bad patch in an otherwise sound strategy, or a longer-term decline.
7. Decide the sell discipline: The multi-manager will determine when funds or managers, deemed to be not performing as expected, are to be released. They will develop policies for when fund prices drop below a pre-set level; for manager departures; for the deviation from the stated investment process; for changes in investment style; for the restructuring of a fund management company; and for when a better investment idea comes along.

Defaqto Analysis:

Effective multi-managers use a rigorous investment process which is likely to be followed painstakingly. They may also bring to bear impressive resources in terms of analysts, proprietary software, and teams of highly able individuals. Your use of multi-manager will turn on whether the value you can add to this by combining and monitoring funds yourself is worth the time not given to client relationships or client prospecting.

5. Outsourcing investment: insourcing relationship building

If managing client investment portfolios takes up a considerable amount of your time and resource then this could be a real opportunity to change your business model. By outsourcing some of your investment responsibilities to multi-managers to develop a premium service to your clients the balance is tilted away from the sales treadmill towards planning, building client relationships, and increased revenues.

- Conforming to the regulations and the compliance for each fund invested for your clients, has increased administration and costs. Additionally with the downward pressure on commissions, profit margins have been squeezed in this area of financial planning. The use of multi-manager funds reduces the compliance burden by achieving adequate diversification with a reduced number of funds potentially leading to a favourable impact on your profit margins.
- Using multi-managers means you will no longer have to monitor the investment performance of a large number of individual funds. This is the job of the multi-manager. You are responsible for selecting the appropriate multi-managers with investment philosophies and processes that most closely match your clients' needs and for ensuring that the multi-manager funds chosen remain appropriate for your clients.
- Appointing multi-managers to run your clients' wealth sends a message to your clients that you are appointing investment professionals. Your knowledge of who to select becomes an expertise that could be an important part of your service proposition.
- Administrative consolidation: One trade from the adviser will purchase a portfolio of collectives. The resulting paperwork, accounting, administration and reporting will now relate to a single multi-manager fund rather than a number of individual directly invested funds, making savings in time and resource for both the adviser and the client.
- Tax planning is more straightforward: Trades by the multi-managers within the fund are free of Capital Gains Tax (CGT) enabling the portfolios to grow at an effective gross rate of tax, while reducing the volume of CGT sensitive trades by the clients. Clients should experience simpler CGT reports.

Defaqto Analysis:

Managing single fund investment portfolios for clients can be a considerable drain on time and resource. Outsourcing this function to multi-manager investment specialists is an option that you may find hard to resist. Their performance record shows that they can be a very viable alternative, enabling you to outsource the leg-work yet retain your investment orientation.

6. Fund availability

Multi-manager funds are available through the platforms and as investment choices within a wide range of tax wrappers such as ISA's, PEP Transfers, Pensions, Onshore and Offshore Unit linked bonds. However beware of limited choice with some products.

- The multi-manager funds available within individual tax wrappers will become a major influence on your choice of product, and you should ensure that the funds available are appropriate for your client. Multi-manager funds are now available as fund link options within most tax wrappers. Often, although not always, they are run by or for the individual product provider.
- All the adviser platforms (often known as wraps) will have a wide range of multi-manager funds to choose from, often at preferential rates.

Defaqto Analysis:

The increasing availability and choice of multi-manager funds through most products and platforms means that you can devise an all encompassing investment strategy based on multi-manager investing. Be aware though, that some products offer a limited multi-manager universe.

7. Freedom means responsibilities investment responsibilities

Employing multi-managers does not eliminate your investment responsibilities. But it does reduce their administration. Your choice of multi-manager fund must be appropriate.

- Ensure that the funds chosen continue to remain appropriate to your clients' risk and return profiles.
- Where you take on the asset allocation responsibilities for your clients, monitor the funds to ensure that their asset allocation remains appropriate.
- Monitor the performance of the fund or funds chosen, to ensure that they are delivering acceptable performance against their peers. You will know your clients' attitudes to risk so ensure that performance, volatility, and risk remains as expected.
- The success of a fund historically, can be attributed to the multi-manager team and/or its leadership. Keep up with any key changes to the multi-manager team set-up, as this may impact future results.
- Clients generally pay a small premium for multi-manager funds over single-fund investing, and although they are receiving professional, specialist investment management in return, it may be reasonable for them to expect improved service from you in other areas.
- Multi-manager may be a good value option for many clients. As a client's wealth increases he or she may prefer a premium personal service. At this point it may be appropriate to consider appointing a private client wealth manager to look after their investment portfolios on a bespoke basis.

Defaqto Analysis:

Appointing multi-managers is likely to save you time and resources, but you will still have investment responsibilities. There are upwards of 300 Multi-manager Open Ended investment companies (OEICs) and unit trusts in the UK, and due diligence still needs to be done to ensure that the appropriate multi-manager funds are purchased initially and that they continue to do what is expected of them.

The Author

Fraser Donaldson
Principal Consultant
– Investments



Career to date

Fraser joined Defaqto in November 1994. Prior to joining Defaqto, Fraser worked at national IFA Towry Law where he was involved in building best advice panels for investment products and was instrumental in setting up the Towry Law Discretionary Management Service in partnership with Mercury Asset Management (now BlackRock Merrill Lynch).

Responsibilities

Fraser is responsible for producing Insight Reports in the investment arena, having written several reports on WRAP, onshore and offshore investment bonds. He is also responsible for developing Defaqto's investment proposition.

Specialisations

Fraser's many years of experience in the investment field equips him to act as a specialist spokesman and commentator on all aspects of the retail financial market. He has also written widely on investment matters.