Combining Managers
Factors to Consider When Combining Managers Together

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We all do this. We all “fill up the pie.” Most of us have some solid reasoning or confidence about the method we use to choose “slices” when diversifying a client’s portfolio. More products in the marketplace means more items to consider when constructing an overall investment portfolio. When beginning to diversify for clients, initial questions include the following:

- What are my goals for this client? To keep up with less risk? Outperform with similar risk? Absolute return, etc.?
- What are my product choices? Exchange-traded funds? Separately managed accounts? Closed-end funds or limited partnerships, etc.?
- How tactical should I be for this client related to style tilts and asset class moves?

This article focuses on the more-liquid separately managed accounts (SMAs), mutual funds, and exchange-traded funds (ETFs) as well as on a client’s goal of outperforming a known broad benchmark with similar risk. The three “pies” in figure 1 demonstrate just a minute portion of the various methods to tackle asset allocation.

As we know, the rule of thumb is that the longer the time horizon and the more sophisticated the client, the more flexible we can be with alternatives, especially illiquid vehicles. Again, the items covered in this article largely pertain to a typical high-net-worth client or small institution that is trying to reach their goals by outperforming a combined and agreed-upon index but with similar or less risk (volatility). There is still a great demand for skilled investors who can raise cash just before the next down market and buy gold before the next quarter’s rise in precious metals. I will leave the flexible top-down moves of wide-swinging tactical asset allocation to the experts who have back-tested their data through various market cycles and found that they would be very wealthy if they had actual clients throughout those time periods.

Equity Portion

A few questions off the bat include the following:

- How many slices in the pie do I want?
- Do I want to own any flexible managers who can cover a few slices?
- Do I want to aim for neutrality regarding style or have a tilt?
- What is my benchmark?

Remember, the benchmark in your mind and the benchmark in the client’s mind should be the same, or you at least need to be ready to explain the differences, possibly every quarter from inception. Often your relationship with
the client can help answer these initial asset allocation questions. Maybe the client appreciates flexibility and holding more dynamic managers as a larger portion of the account or, on the other hand, maybe the client will feel left out if a slice of a hot asset class such as precious metals or emerging market equities is missing. Maybe the client does not like derivatives or is more sophisticated and wants a larger portion in absolute return products such as those owned by big college endowments.

We have all seen or heard about endowments and foundations that have large alternative allocations because they have the luxury of very long time horizons and slow withdrawal rates. If assets in these institutions are large enough, the assets can go into illiquid securities and somewhat risky investments if combined properly. The portfolio construction exercise is a bit more challenging with, for instance, different lock-up periods and delayed pricing. As with long-only and more traditional vehicles, setting expectations based on performance patterns, risks involved with each piece, and correlation simulations are also important for success.

Let’s return to the example of a typical higher-net-worth client and fast-forward to an agreement on a benchmark of the MSCI ACWI (All Country World Index) for the equity portion of the pie. We’ve determined this benchmark by simulations of forward-looking asset class projections overlaid with reasonable constraints (to avoid an account of 50-percent illiquid private equity, 35-percent real estate investment trusts (REITs), and 15-percent emerging market debt (EMD), for example). The ACWI may have too much non-U.S. (around 50 percent), so our home-country biases may bring us to a 75-percent S&P 500 and 25-percent MSCI EAFE instead, for the equity portion. For this discussion our process has neutrality as a goal over the longer term (style, beta, etc.); in this example, collectively determining that Fama and French value tilts make academic sense until a financial crisis occurs and turns many cheap stocks into value traps, or that when growth is beating value it can turn quickly against your bet.

The demand for tactical, flexible, dynamic, and absolute return products is most likely here to stay. The global stock market’s terrible returns during 2008 and non-U.S. equities’ double-digit losses during 2011 resulted in a risk-on, risk-off market with most participants trying to preserve client capital and preserve clients’ period. The difficult part of combining more than a few dynamic/flexible SMAs, open-end funds, or ETFs in one account is that these managers may flex or tilt the same way at the same time; raising cash in an up market, overweighting international stocks while foreign companies are out of favor, or unfortunately loading up on the same hot stock as the market is topping out. One method to overcome the potential pitfalls is to carve out a portion of the account (20 percent, 30 percent, etc.) for tactical managers to manage, allowing them flexibility in the hope of earning good returns and protecting capital in that sleeve. The other method of owning dynamic managers is to sprinkle a few among the more traditional style-box managers to accent the slices across the pie.

What you really are attempting is to predict the future return patterns for each slice of the pie and combine those expectations to ensure your overall goal, at least on paper. The due diligence process in all cases must include analysis on the history and expectations of 1) risk levels, 2) style tilts, and 3) sector biases.

**Risk Levels**

In simple terms, risk levels can be thought of as beta (versus an appropriate benchmark) or relative annualized standard deviation of past returns. If the people and process are still in place, relative standard deviation and beta versus the style benchmark often are consistent through time. In fact, investors often are better off holding an underperforming manager who has a consistent risk pattern rather than trading to a new manager with better performance. Note that flexible or tactical managers often need a couple market cycles to prove their beta profile. Typically managers with concentrated products, low cash, and sector emphases often have high betas. Managers who hold many stocks, higher cash weights, or favor high-quality businesses (consistent profitability and earnings through most cycles) tend to have lower betas. Using past total returns for the product, it is important to look at rolling time periods such as one year, three years, and five years at a time throughout the portfolio management team’s history.
to determine the future expectations. Figure 2 shows the volatility pattern of an absolute return product using rolling 12-month historical observations.

Again, at time of investment you or your client may have a predilection to high-beta managers or low-beta managers, but the popular school of thought related to our stated goal is to pair combinations of each in a beta-neutral portfolio, in the hope of allowing the client to outperform with manager alpha. ETFs (index trackers, low cost, high volume) can be very helpful in placing beta where alpha is more difficult to obtain. In other words, you can spend most of your risk budget in more inefficient areas such as small cap or emerging markets with managers having higher tracking error and residual risk, if their alphas have proven to be worth the higher risk. Finally, if you decide it is prudent to hold 10–20 percent of the portfolio in hedge funds or alternative-type mutual funds, for example, the goal is typically to seek good returns with low correlation compared to the other managers to dampen downside volatility. Due diligence on alternative products and overcoming the challenges of short track records and complicated derivative holdings is beyond the scope of this article. Figure 3 shows a predicted volatility pattern of a global manager using actual holdings projected over the next 12 months.

**Style Tilts**

Style tilts, such as growth versus value or large versus mid-cap, can also be very influential in return patterns for clients. Again, you may want to tilt based on your market views. If your top-down view led you to overweight large value over large growth or mid-caps over large caps in most of the 2000s, you did well for clients. For example, during each of the calendar years 2000–2006, the Russell 1000 Value outperformed the Russell 1000 Growth. Then the Russell 1000 Growth outperformed significantly in 2007, and also in 2009, 2010, and 2011. With regard to market cap, the Russell Midcap Index outperformed the S&P 500 Index nine of the 11 calendar years from 2000–2010. Managers often have biases in their processes that lead to their own tilts, such as holding companies with higher projected earnings, which often include high price-to-earnings (P/E) ratios, or holding out-of-favor stocks with relatively lower projected earnings (accompanied by low P/E ratios). Substyles also can show different performance patterns, such as deep value (very low P/E and earnings projections) versus relative value (typically higher P/E than Russell 1000 Value but with higher earnings-per-share growth too). Computer systems can run returns-based style analyses that specify the combination of indexes that the manager’s past return pattern best tracked. Figure 4 shows a holdings-based style map or imprint. Each manager’s holdings are overlaid versus a neutral benchmark, e.g., both are compared to the Russell 1000 Index. For the growth manager, the magnitude of the ratios above 1.0 for price-to-earnings ratio, price-to-book ratio, price-to-sales ratio, and estimated earnings per share growth may indicate the substyle versus other growth managers’ pictures. The low dividend ratio makes sense, with many high-earnings companies paying low dividends. These style pictures from the appropriate growth and value managers can be combined to make a neutral-looking portfolio. It is important to marry holdings-based historical analysis with past returns-based data before combining managers. Returns-based answers alone do not consider which stocks were held, and the grouping of certain types of known stocks can change over time and lead to abnormal return patterns. Also, running the past correlation of total return or excess return of potential managers usually paints a good picture of diversification. Note that some managers are more flexible with market caps so scrutiny should be placed on consistency or trends with, for example, mid-caps held in a large-cap discipline. For experts there are even more factors from advanced systems to analyze while looking at holdings, such as earnings variability, debt levels, industry correlations, momentum characteristics, trading volume, and even projected tracking error. With the proper information and managers whose processes are consistent, our style-neutral goal can be obtained by combining growth characteristics with value characteristics along with the appropriate amount of the different market capitalizations.
Sectors Biases

Sectors change more from quarter to quarter for active managers than risk patterns or overall investment styles, so this may not be a primary consideration—but it’s often one of the final checks when pairing managers. We all have learned that too much of a good thing can be a bad thing (technology in 2000–2001, financials in 2007–2008), so while researching holdings it is helpful to look for sector consistencies, flexibilities, and biases over time. For example, figure 5 shows a mid-cap value manager that has shown a slight bias against the technology sector.

If you have a constructive opinion on future price performance of technology stocks, you can find managers who typically like to overweight that sector. But with sector bets typically comes extra volatility, so if you do not want the risk with sector emphases, it is best to neutralize past and expected sector weights if possible. In our MSCI ACWI benchmark example, with proper tools the international managers can be analyzed just as the U.S. equity portion is analyzed.

Fixed-Income Portion

The importance of proper analysis regarding the combining of fixed-income managers was highlighted in 2008 and also is paramount in the current environment of low interest rates. For example, duration as a concept is not difficult to explain, but many clients likely do not fully understand the adverse effects of a rising rate environment on their high-quality bonds. Notwithstanding that typically more intricate holdings-based tools are needed for fixed income because of...
the numerous issuers (e.g., mortgage-backed securities, municipal bonds, and derivatives), the goal of finding good consistent alpha managers and diversifying risk to resemble the benchmark is basically the same as equity.

When combining fixed-income managers the key aspects to focus on include quality, risk levels, sectors, and currencies (see figure 6). The concepts are the same: Use returns-based analysis and optimization when combining fixed-income managers while paying special attention to how each manager’s process drives them to biases in quality (junk bonds versus high quality), risk (low or high duration), sectors (governments, corporates, mortgage-backed securities, Treasury inflation-protected securities, municipal bonds, etc.), and currencies (U.S. dollar or foreign currencies). If you have access to holdings, then construct appropriate sector and risk buckets to compare historical tendencies and properly match up managers. Many of the large mutual funds are fairly flexible and are best paired with managers with more specific mandates and consistency. If your client’s benchmark contains bonds, diversification among fixed-income managers is nearly as important as combining equity managers. In general, clients expect a consistent yield and low volatility with their bonds, so overall quality, duration, sector weights, and currencies are key ingredients to meeting expectations.

In Summary
It may be time to refine and enhance your process of combining managers in a portfolio. Tools and risk systems have evolved to be very helpful when analyzing both the past and the future. Coincidentally, the marketplace has been flooded with tactical products and alternatives, which has made the construction process a bit more challenging. The importance of analyses over many market cycles is paramount; meanwhile, many of these products are fairly new. The frequency of checking performance patterns and actual holdings, for example, must increase in your process; these main inputs apply universally across most asset classes. Start with getting your hands on as much data as possible, regress the past performance monthly or more frequently versus varying indexes and potential combinations, compare the actual historical holdings monthly or quarterly versus the proper benchmark and other investment choices to determine biases, and combine the pieces with your overall risk and return goals in mind. Finally, be willing to scrutinize and improve your process over time as changes in the global financial markets bring potential asset allocation changes with them.

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