“The blending process strengthens the risk framework of the portfolio as successfully combining managers with different styles and attributes can help to reduce the extremes of volatility”

An overview of our approach to blending managers

1. In order to achieve positive returns an investment manager must take risk.

2. For this reason our process is risk focused, seeking to understand the risks that managers take to achieve their target returns and to understand how they do this.

3. The essence of this process lies in an accurate understanding of a manager’s investment philosophy and disciplines, through detailed analysis and judgement.

4. An important part of this process is the decomposition of each manager’s risk profile, into benchmark related sources of risk (beta) and non-benchmark related sources of risk (resulting in alpha).

5. This process allows us to identify high conviction managers who display different characteristics - all of whom we believe have the potential to outperform their stated target.

6. These high conviction, yet different, managers, form the ingredients of a blended portfolio.

7. The blending process itself seeks to harness different types of risk as a result of the managers’ diverse skills sets and to do this in an optimal way.

Why is manager blending important to results?

Manager blending is important for two primary reasons – it provides (i) enhanced performance potential (ii) within a more efficient risk framework.

In essence the blending process is designed to enhance the performance potential of a portfolio by harnessing different return sources whilst also helping to provide a more stable performance stream over the length of a market cycle. At the same time the blending process strengthens the risk framework of the portfolio as successfully combining managers with different styles and attributes can help to reduce the extremes of volatility inherent in any one specific style/factor exposure.

Selection and blending – an introduction

As an asset manager, we are in the business of making money for our clients by taking calculated risks and with the aim that our clients are commensurately rewarded. Rather than investing directly in equities, bonds or derivatives, we focus on hiring specialist teams within different investment management groups, where we consider the chosen team to be some of the best in their respective field. The objective is to generate excess performance for our clients versus an appropriate market benchmark.

Although investors must take risks to generate returns, by diversifying risk in a portfolio context (where some risks can be diversified away), investors can hope to achieve greater returns for a given level of risk – through efficiently combining investments. This principle of diversification applies not only to a portfolio of stocks or bonds but also to a portfolio of funds or managers, and explains all the effort we dedicate to blending managers effectively.

“We need to be able to justify a level of conviction in the manager’s ability to deliver on their own stated objectives in order to invest with them”
There are essentially two elements to our task; to ensure that our blend of managers is in aggregate appropriately rewarded for its manager specific risks, as well as the direct market exposure risks that the managers will take on our behalf. First we need to be able to justify a level of conviction in the manager’s ability to deliver on their own stated objectives in order to invest with them. At the same time, we need to have developed a sound understanding of the principal risk and return drivers of different markets to be in a better position to understand likely manager behaviour at different junctures, and build a portfolio that is potentially better able to withstand market uncertainty whilst delivering on its performance expectations.

Whilst the selection of managers through research is an essential part of our investment process, the blending of the managers we like is just as important a task, and one that comes with its own set of challenges.

“How do we define blending?”

Blending managers is essentially the process of optimally combining different managers that offer complementary characteristics. We seek to combine managers with different investment processes, risk preferences and characteristics within an appropriate blend.

To do this it is important to understand the many different facets of each manager and their, often complex, investment processes.

The objective of a blending process is to smooth out some of the risk biases inherent in any individual manager’s process whilst continuing to capture the excess return potential that each manager offers through a cycle. As a result the blending process itself employs both qualitative analysis and quantitative analysis and incorporates the use of historic information and forward looking judgement.

“The objective of blending is to smooth out the risk biases inherent in any individual manager’s process whilst still capturing the excess return potential that each manager offers through a cycle”

The quantitative part of this process is mostly focused on helping to decompose risk exposures. It can provide us with important insights to the differences between one manager and another and therefore their potential complementary nature.

It is important to note that risk is multi-dimensional, and transcends those facets that can be captured on a purely quantitative basis. Examples of such areas include the use of large firms versus small firms or targeting quantitative processes versus non-quantitative processes.

“Alpha returns should by definition be more persistent, as they depend on inefficiencies (risk) that are not efficiently priced by the market”
“Final judgement is based on a combination of quantitative and qualitative inputs, our understanding of historic drivers of risk and return and our forward looking expectations resulting from this”

What is our approach to blending managers?

We use a number of tools to both analyse and understand a manager’s process and to decompose its sources of risk. Our final judgement is based on this combination of quantitative and qualitative inputs, our understanding of historic drivers of risk and return and our forward looking expectations based on this knowledge.

The risk that drives excess returns can be the result of emphasising certain benchmark related risks (e.g. size, style, region, sector), generally known as beta, that are clearly identifiable and can be captured by risk systems. It can also be the result of undertaking non-benchmark related exposures, generally known as alpha sources.

Alpha sources can include bets in stocks not included in the chosen benchmark for example or stocks included in the benchmark but which move differently to their industry/sector/country/region peers – due to stock specific characteristics that drive returns. Such bets are typically the result of a particular competitive edge that a manager may enjoy, whether it is differentiated research (some information edge developed by the manager) or differentiated portfolio construction.

This edge typically originates from specific expertise that lies within a manager’s investment process, for example their insight into earnings, valuation, technical or behavioural factors and analysis.

Conversely, unless we see long term structural rewards to a beta exposure (like style, size, sector, region) we are unwilling to introduce such biases within our fund portfolios as part of our blending process. This is because beta exposures are difficult to time and although the potential for excess return exists versus a benchmark, it may not always be a positive return.
“Unless we see long term structural rewards to a beta exposure, we are unwilling to introduce such biases as part of our blending process because they are difficult to time and may not be rewarded with positive results”

Fig. 2. We track a range of factors to assess the ongoing application of a managers approach

We use quantitative inputs within our qualitative process

There are a number of risk systems (such as ‘Barra’ and ‘Style Research’) at our disposal. These tools provide a useful starting point by giving us access to detailed information regarding historic risk exposures and sources of returns of the chosen managers. This allows for an exhaustive analysis of a manager’s investment record and the pinpointing of what benchmark relative exposures were undertaken at what point in time. This provides another very useful input to our discussions about what types of behaviours or risk exposures are likely to persist and what types are likely to change through the market cycle.

An example of the factors which we track on an ongoing basis is listed in Fig.2. above. The chart illustrates the change in a managers style over a period of time. Each ratio shown on the horizontal axis indicates a particular style factor that can be tracked. The larger the size of the circle, the more recent the point in time that the trait has been observed. We use the information to inform our qualitative questioning of managers.

“Numbers can sometimes lull analysts into a false sense of security and leave them less able to cope with the uncertainty that is a permanent feature of financial markets”
“We draw from our team’s cumulative experience and understanding of the manager’s investment philosophy, process and likely risk taking behaviour, to create blends that achieve adequate diversification across different beta exposures as well as sources of alpha”

Fig. 3. We seek to combine managers with complementary styles, risk exposures and alpha sources.

### A process built around qualitative judgement

Whilst we recognise the usefulness of the quantitative tools, we cannot stress enough the importance of a qualitative judgement overlay, when forming forward looking risk/return expectations. More often than not, we have observed how the simplicity of numbers can sometimes lull analysts into a false sense of security and leave them less able to cope with the uncertainty that is a permanent feature of financial markets.

Whilst risk models go a long way to help us understand manager exposures, they also have some serious limitations: not least of which is the fact that outputs are dependent on the availability and accuracy of returns or portfolio holdings data, and they are designed to make simplifying assumptions about the shape of statistical distributions of data, and the stability of variables and relations between variables in order to facilitate the modelling process. As a result, quantitative models require compromise to enable them to cope with the complexity of real world financial markets.

With this in mind, our investment process draws not only on risk model outputs but also on the team’s accumulated experience and understanding of the manager’s investment philosophy, process and likely risk taking behaviour, to create a blend that achieves adequate diversification across different beta exposures as well as sources of alpha.

Fig.3. Indicates how we might seek to blend managers that exhibit complementary characteristics in an effort to create a potentially optimal risk return dynamic. Even though each of the managers will have been highly rated in our research process, there is little to be gained by combining good managers if they share similar style attributes since they are likely to be in or out of favour at the same time. The grey boxes indicate simplistically where a particular trait is exhibited by a manager, whilst a white box shows where that trait is not a prominent component of that managers style.

Overall, that chart illustrates that the objective of blending managers is to create a situation where manager skill is evident in all of the managers selected but that the styles of manager are combined in such a way as to create exposure to the full range of factors at the portfolio level - the aim being to deliver excess returns relative to the portfolios benchmark whilst at the same time making every effort to reduce the potentially adverse short term volatility that would otherwise occur as a result of the cyclical nature of an individual managers fortunes.
“The objective of blending is to smooth out the risk biases inherent in any individual manager’s process whilst still capturing the excess return potential that each manager offers through a cycle”

Popular “style” terminology is not useful when professionally blending managers

It is current market practice to use generic style descriptors to characterise a manager’s process or a portfolio. For example, “value” or “momentum” are terms that can be used to pigeon-hole managers for the purposes of blending. However we consider these to be simplistic as they reflect only a partial view of what is actually going on.

Instead we dedicate a great deal more in-depth analysis to the manager’s performance record and process characteristics to tap into what is actually driving their measured risk exposures (benchmark and non-benchmark related) and make a judgement on how persistent these are likely to be, in order to support a better informed view of their process.

The outcome is, hopefully, a well founded and well thought out blending approach, rooted principally in our research capabilities.

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Multimanager team – key facts

- We conduct manager research globally with regional and local offices in 8 locations
- Our team manages over USD21.8bn AUM (as at end November 2012)
- We have a consistent and global 5 stage investment process with quantitative and qualitative analysis
- Our three key areas of expertise are underpinned by a common investment philosophy: 1) Firm due diligence, 2) Manager research and selection, and 3) Managed products
- We have institutional and wholesale clients all over the world
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To help improve our service and in the interests of security we may record and/or monitor your calls with us.

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