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Multi-managers – talk or substance?

One of the biggest marketing efforts at the moment is in the field of multi-manager investing. At first sight it seems a great idea, spread your risk, get a better risk-return profile – but have multi-managers really been delivering this? And just what criteria should we use to test it? We will try answering this for UK equity funds, starting in what may seem an unrelated area – the FTSE350 index, and some of the characteristics it has displayed. (All underlying chart data is from the (deliberately unnamed) multi-managers, CAPS and FTSE.)

The FTSE350 is the index for the largest 350 companies in the UK. It has been published with a subdivision into high (dividend) yield and low yield since the beginning of 1995 (with a backhistory as well, for those who like extensive data) – these can be thought of as “value” and “growth” subsets. Stocks move between the two subsets on an annual basis so as to maintain a 50/50 split by market capitalization between the subsets. Figure 1a shows the total returns for the FTSE350 and the two complementary subsets, scaled to a start of 1000 as of the end of December 1994. Figure 1b shows the returns for the two subsets relative to the FTSE350 as a whole (fixed at 1000). Note that the market capitalizations of the two subsets can (and do) differ from 50% each within the year, because of the frequency of rebalancing. At December 1999, when “growth” was in favour, the high yield section was dominated by Oil and Banking stocks, whereas the low yield one housed Telecoms and Pharmaceuticals.

Figure 1a: Absolute total returns

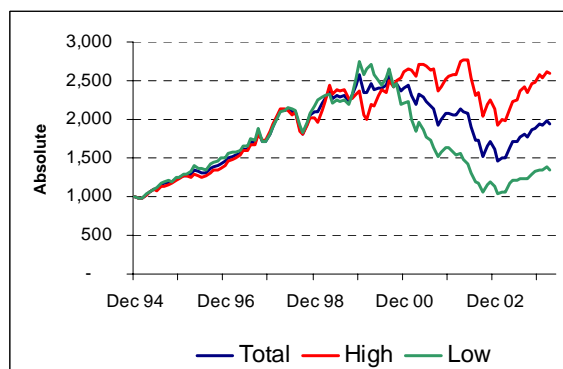
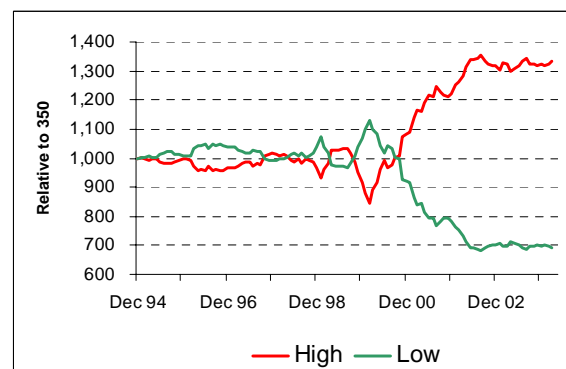


Figure 1b: Relative returns



For the first 4 years, there was hardly any difference between the subsets. With the technology bubble in late 1999 there was a brief period when low yielding stocks were just over 10% ahead of the index as a whole (and high yield stocks were 10% behind, as expected from the subsets’ complementary definitions), and then parity resumed in late 2000. What has been remarkable is that after the next 2 years or so, in which high yield stocks gained over 30% relative to the index (and low yield stocks lost a corresponding amount), a prolonged steadier period has emerged where the recovery in stocks has been shared evenly between the subsets, rather than giving back the low yielders some of the relative return they had lost – it is as if there has been a re-rating of the subsets.



Figure 1c: Relative returns by size

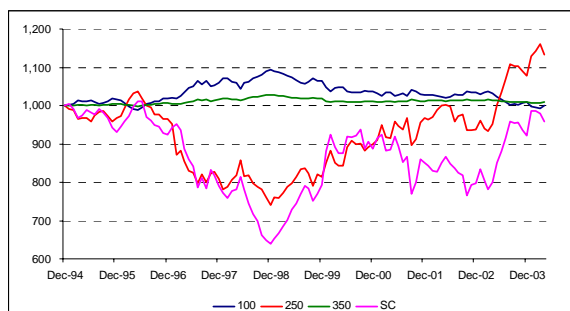


Figure 1c shows the returns relative to the All Share in the same units as for Figure 1b. The chart clearly shows the extent to which Small and Mid Cap (250) stocks can move in and out of favour, and the speed at which this can happen.

So what does all this imply for multi-managers? At the very least, a good reason for them to exist, for Trustees trying to avoid being exposed to a single manager with strong value or growth characteristics, or an undue bias to Small or Mid Cap stocks. But what have they delivered in practice?

We look at quarterly relative returns (quoted net of annual management fees, but not of performance fees, which can sometimes apply but are generally subject to separate negotiation), and we relate these to the resulting longer term relative results. First, a few observations on how multi-managers build their portfolios.

Each portfolio should involve more than one manager (although on size grounds, some multi-managers do start or run some products with single managers). Note that the weightings given to managers should arguably be risk-weighted, but some multi-managers prefer an equal weighting approach. The diversification created is usually one of three types: combining high-performance 'niche' managers or a general spread for general diversification or using a constructed spread for (supposed) targeted diversification.

The third approach (more so than the other two) can help reduce the exposure to factors such as value/growth or size, as outlined earlier. However, some view it as claiming spurious scientific support. Further, in all three cases, index-like returns may still emerge if too much diversification is employed (and / or some of their selected managers underperform).

In an ideal world, the relative return pattern would be wonderfully steady quarterly relative returns, compounding up to solid reliable longer-term results. In particular, you want to see the pattern offering something fundamentally more appealing than the (often volatile) relative return chart of a typical single active manager. However, you've got to go one stage further when assessing the multi-manager's results – if they have had a period of steady results, has this come from skill after genuine diversification, or from an element of style bias that paid off over that period?



Figures 1a-1h show the (anonymous) relative return charts of the six main multi-managers operating in the UK with two other (single) active managers smuggled in – readers may wish to guess which they are before continuing reading? We have given as long a back-history as we can, including pre-launch simulations where available, rather than restrict to any particular recent period. (NB the vertical scales vary slightly between the charts, and for 1g in particular.)

Figure 1a:

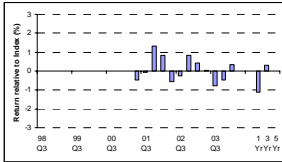


Figure 1b:

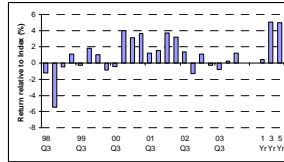


Figure 1c:

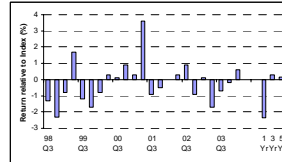


Figure 1d:

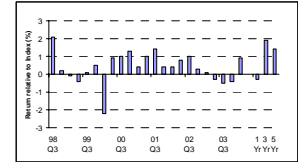


Figure 1e:

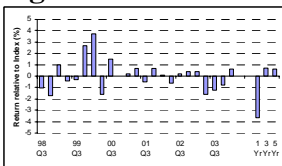


Figure 1f:

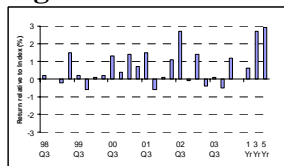


Figure 1g:

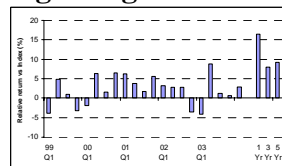
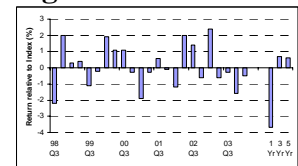


Figure 1h:



From these, 1b, 1d, 1f and 1g all appear to be "smooth". The other four "unsmooth" cases are all multi-managers. Within the "smooth" results, 1d and 1f are the single manager examples. Of the other two, 1g employs niche managers (rather successfully, we have to say!), although not all Trustees are comfortable with that, and we have reason to suspect that style bias paid off for manager 1b during their main period of smoothness.

Overall, on the basis of what they have delivered at this stage in the development of UK Equity multi-manager products, we think the multi-manager case is far from proven (and we are not going to be popular for putting our heads above the parapet in saying this!).

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