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The multi-asset manager meets the monkey

Today's increased market volatility demands allocation skill from managers, separating the good from the bad

FEBRUARY'S spike in market volatility, correction in equity markets and increase in US 10-year bond yields towards 3 per cent was long awaited, and has significant consequences for asset owners and their multi-asset managers. As a retail investor in a lifestyle fund (conservative, balanced or aggressive) or a CPF account, a high net-worth client of a private bank, or an institution evaluating multi-asset managers (such as the Singapore Accountant-General's Department), this is the most crucial period to determine if you have the right multi-asset manager.

The last few years have been really easy for everyone. Even a monkey throwing darts to decide the allocation between equity, credit and treasuries would have delivered healthy returns, as all asset classes went up. But this was luck, not skill. The increased market volatility will now demand allocation skill from the manager, separate the good manager from the bad, the skilled manager from the monkey. Here are a few tools to help distinguish a skilled manager from a monkey.

1 An absolute multi-asset mandate requires a cash benchmark

All asset owners – be it endowments, sovereigns, insurance, pensions, corporate treasuries, high net-worth individuals or retail investors – have an objective of absolute return to meet liabilities. Yet while they specify this requirement in multi-asset mandates, concurrently they agree to a hybrid market benchmark such as 60-40.

Apart from being contradictory, this confuses the manager's responsibility and accountability. Given a 60-40 benchmark, the manager will simply implement a relative return strategy, where he does not need to perform any active allocation, and absolves himself of all responsibility of protecting against market draw-downs. This defeats the very purpose of investing in multi-asset strategies, which are supposed to provide return in any market regime.

All asset owners must insist on only a cash benchmark to their multi-asset manager, with risk specified as a maximum peak to trough drawdown. It is the manager's responsibility to have an allocation and risk management process to manage market volatility and draw-downs. They should not be allowed to use a 60-40 benchmark to justify absolute negative performance.

2 A performance attribution report from your multi-asset manager is essential

Basic finance teaches that 80-90 per cent of the risk and return of any portfolio comes from the allocation decision, and only 10-20 per cent from security selection. The first thing to know is: "How much of your portfolio return was from luck (that markets happened to go up) and how much was from investment skill (active allocation or security selection)?"

The return generated by a 60-40 benchmarked portfolio is not manager skill, it is luck that markets went up. Only the return above this can be attributed to manager skill. Even though a performance attribution report provides this information, it is surprising that investors do not demand this from managers. For institutions acting as fiduciaries, it is almost irresponsible to invest with multi-asset managers who do not provide a performance attribution report.

3 Never invest with a manager who does not understand, measure, monitor and manage risk

While risk management is always important, it is paramount in periods of regime change. In the last few years, managers who simply took more risk – and thus produced a higher return – were incorrectly thought of as better. The prudent manager – who appropriately took measured risk – was chastised as he had a lower return. We witnessed this at the last regime change when the global financial crisis started in August 2007. A spike in volatility and market fall on Aug 7 was followed the following days by a reversal. No one really knew what was happening. The prudent manager correctly implemented risk management and cut portfolio risk to protect capital, while the manager who was on the beach, who did not have a risk management process, did nothing.

When markets bounced, the prudent manager was not able to participate fully in the short-term recovery, but the manager on the beach recovered the losses simply by luck. But who would you rather have managing your money: the manager who was careful or the manager on the beach?

We are at that same point in history today. Any manager whose only risk process is "I will sell equities before the market falls" is naive and already on the beach. No one – yes, no one – can time markets; and without a comprehensive risk management process, a manager is simply unfit to manage client assets.

4 Managers who have many diverse sources of return are more likely to deliver a superior solution

Financial markets have diverse opportunities across the world. As nothing works perpetually, managers with multiple return sources to access these opportunities are likely to provide a superior multi-asset solution. Many recent managers have had only a single trick – equity managers who simply loaded up on technology stocks, and bond managers who loaded up on China credit. While these managers will always claim that they evaluate every stock and credit rigorously, the simple fact is that if the majority of a manager's skill return is coming from one bet, he cannot perform when that one trick pony stops working. Managers who can demonstrate that their return comes from multiple concepts, more than China credit or technology are likely to be superior.

5 Managers who are able to invest across active, passive and smart beta strategies, are likely to deliver better multi-asset solutions

The merits of active strategies, passive exchange-traded funds (ETFs), and smart beta or risk premium products has been widely debated. Active managers argue the value of uncorrelated return, passive managers argue the benefit of low fees, and smart beta managers argue prevalence of long-run factor returns. From a multi-asset perspective, it is important to note that managers who have the option to invest in any of these products will likely provide a more efficient investment solution than managers who are prevented in doing so for business or philosophical reasons. Multi-asset by its very definition requires the ability to incorporate any kind of strategy to formulate an efficient investment solution.

6 Access to global investment products will enable better multi-asset solutions

For multi-asset solutions, a wide geographic landscape of strategies provides a superior toolkit of allocation and implementation possibilities than simply a set of regional products. As such, a manager with access to products across all global regions is likely to be better positioned to provide a holistic multi-asset solution.

All asset owners must have a part of their portfolio invested in multi-asset strategies, as it diversifies the risk concentration caused by a single allocation decision, which can be the primary cause of not meeting expected returns or excessive portfolio draw-downs. But the asset management world has both skilled multi-asset managers and monkeys, and it is important to implement these basic guidelines to help ensure that they do not end up with a monkey managing their assets.

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