BIZCOMMUNITY

Multi-asset funds are managed by experienced asset managers

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Portfolio flow statistics from the Association of Savings and Investment in South Africa over the last few quarters have shown a significant rise in the percentage of industry assets moving towards funds which may invest into multiple asset classes where exposures to these asset classes are actively and tactically managed.

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These types of funds would typically be included in various savings options and retirement funds which are regulation 28 compliant. This has resulted in many portfolios comprising exclusively multi-asset class funds, rather than the traditional method of combining specialist asset class funds (i.e. equity, bonds, and property). In this article I will explore some of the benefits of this approach and explain how it differs from a traditional building block method.

Historically multi-managers and savvy investors who fancied themselves as portfolio managers would construct investment portfolios combining a number of specialist funds. They would weight them appropriately to reach a desired asset allocation. Based on market conditions they would then tactically change the allocation. This method is typically referred to as a building block approach. In this approach the portfolio constructor would select a particular specialist manager they deemed superior to others.

Two core skills

For example, they would select asset manager X to manage local equity, manager Z to manage local bonds, manager K to manage local listed property, etc. Hence this portfolio construction method requires two core skills, the ability to pick the correct asset manager and the ability to strategically and tactically asset allocate between the managers and asset classes.

On the other hand, a multi-asset fund split-funded approach simply aims to select and blend superior asset allocation funds, with the ultimate aim of achieving a particular investment objective. This strategy can simply entail selecting four balanced funds with an equal weighting where the investment objective is to outperform the average balanced fund.

Another method is to select multi-asset funds across the various multi-asset categories and blend them to meet the risky asset limits to achieve the required performance or income requirement/target. This allocation can remain fairly static where there is conviction that the long-term allocation is appropriate.

So what are the benefits of using this strategy? Firstly, it's much simpler than a building block strategy. One major reason is that to effectively manage a building block strategy for a sustained period an investor would usually need to perform robust macro-economic (also referred to as top down) research and constantly be evaluating the investment prospects of every asset class. This is assuming that the investor aims to actively asset allocate within the portfolio rather than sticking to a static allocation to the building block funds.

Risk management

The strategy also improves risk management in the portfolio in a number of ways. First, the risk of selecting the incorrect manager to manage one part of the portfolio is mitigated. In a multi-asset class portfolio of four funds you have four asset allocation views as opposed to one in the building block approach. This diversifies the risk of getting the tactical asset allocation wrong. Risk is further reduced in this strategy as the tactical asset allocation is done in the underlying multi-asset funds.

This typically occurs much faster than using building block unit trust funds as the turnaround time to put through a portfolio asset allocation change in a building block strategy would take a number of days (due to the nature of how unit trusts are administered). The asset manager in a multi-asset class fund can (assuming there's sufficient liquidity) however make changes within the fund in the same day.

Multi-asset class fund managers also have more tools to manage asset allocation and risk than a typical building block manager. They have the ability to hedge currency and equity risk using derivatives within the unit trust whereas the building block manager would need to switch out of the respective fund to reduce risk in a similar way.

Another factor which sometimes also gets overlooked, especially by discretionary investors, is the capital gains tax (CGT) implication when running a building block strategy. For a multi-managed fund of funds this is not an issue as it is done within the unit trust. For the building block strategy each tactical asset allocation call triggers a CGT event. Over time, the CGT impact on a highly active strategy can be particularly detrimental to net performance for an investor's discretionary savings.

Misconceptions

One of the misconceptions about a multi-asset split funded strategy is that the client pays extra for the active asset allocation and hence the multi-asset class funds are significantly more expensive than building block funds. In reality though this is not necessarily the case as many of these funds have become progressively cheaper over time, especially as their assets have grown in size.

There is a middle ground though for investors who still want to take the occasional active position towards a specific asset class. This is called a hybrid strategy where building block funds are added as 'sweeteners' to the portfolio. Investors who follow a predominantly multi-asset fund strategy would take these active positions when they feel particularly bullish on an asset class, especially in cases where the underlying fund manager does not have much exposure to it.

This may be due to size constraints (particularly when investing in property or small-cap stocks), manager preference and skill. Should the investor have no strong view on any asset class the building block funds can simply be removed and re-allocated to the "core" of multi-asset funds. In this way the investor gives the asset allocation responsibility back to the multi-asset fund manager.

The most important reason that the multi-asset split funded strategy works is that most retail investors simply do not have the time, experience or capacity to successfully manage asset allocation. Multi-asset funds are managed by asset managers who have investment teams with significant depth and breadth of experience. They are more than capable of effectively managing strategic and tactical asset allocation.

If you as an investor are able to select four superior fund managers within a relevant risk profile, the probability is high that the portfolio should outperform its investment objective and benchmark consistently.

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