WHY JUST 'BEST-IN-CLASS' AIN'T GOOD ENOUGH

By Dr. Cord Hinrichs

We show why a more sophisticated and holistic approach to portfolio construction will lead to more stable and better outcomes for investors, but requires already an adjusted approach to screening and selection.

'Did we select the best manager?' – This is often the question asked in investment committees or board meetings. But is it the right question? While the intuition to always go for the 'best' manager in each asset class to reach (out)-performance goals is tempting, it is fundamentally flawed. The correct question asked should be: What is the 'best' manager to add to a specific portfolio?

Multi-manager institutional portfolios have grown increasingly complex over the last decades and numerous challenges, some obvious, others less so, determine if long term performance goals can be met. The first and foremost challenge is naturally to identify skill in the multitude of asset managers available to fill the portfolio allocations to different asset classes.

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From a total portfolio perspective as well as within each sub-asset class, the focus should not be to simply select the best managers, but instead build a portfolio with the best mix of managers. This mix should ensure style complementarity and minimal overlap to provide diversification leading to reduced risk while still maintaining legitimate outperformance potential to meet long term objectives.

Uncontrolled aggregation of each of the managers' underlying exposures to different risk factors or styles can result either in significant over-exposure to, or cancellation of, certain risk factors.

The first case results in hidden and unforeseen overall asset allocation bets, for example structural bets against the respective benchmark, therefore exposing the investor to inadequate and unintended risks. That this can happen quiet easily has been evident over the last few months with the so-called FAANGs, dominating not only the US equity beta, but also the managers' alpha.

The other less dramatic, but still painful, pitfall would be to combine managers, while all being the top pick of a selection process in each separate asset class, who cancel-out each others' bets on an overall basis, leaving the investor with an index-like exposure but paying active management fees; in other words, a very sustainable source of underperformance!

One way to portfolio construction up till now has been to 'fill the boxes', that is selecting different managers from different quadrants of 'style boxes'. The idea behind this is to split the investment universe in smaller buckets (for example value, growth), so that for example a 'value' manager does pick stocks only from a value bucket, but not from the growth bucket of the respective growth manager – so that none of the two pitfalls mentioned above can happen. But in practice, the split is rarely as clean as expected and the investment universes overlap, and so do the resulting alphas.

While style boxes are a helpful tool to classify and screen managers to start off with, as a whole they might be too rigid and limited in scope and force the investors as well as asset managers to fill or fit a 'single' part of the box. In reality, investor portfolios are much more complex and in addition, some managers' investment strategies might not fit entirely within one square in the style box, leaving them moving from square to square with each passing quarter. Hence, the scope of a standard style box might not be the most sensible basis for screening to start off with.

The base for building stable long term institutional portfolios should be a thorough understanding not only of the asset managers in question but equally important of the underlying respective benchmark and how its asset class behaves throughout different cycle stages. Fundamental to the selection of successful managers for the portfolio is an in-depth granular analysis and understanding of benchmark and asset class characteristics based on sophisticated and customized analytical approaches which go well beyond standard manager databases in terms of breadth and depth and which require a leading-edge technological framework and toolset.

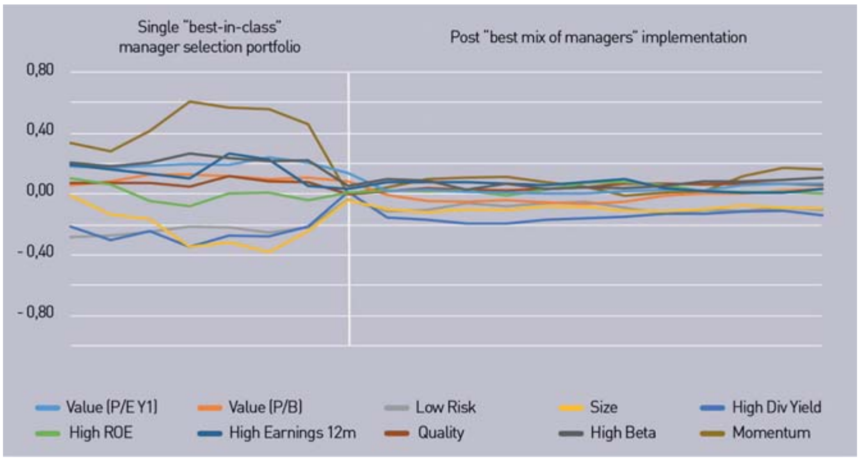
Screening of potential managers should always be based on this in-depth understanding of the underlying index to ensure that screens and selection processes make sense. If, for example, credit managers need to be identified, which have added value through a full cycle, the first step would be to identify credit market specific factors and inflection points in order to identify managers who have performed well in different environments.

Screening over different periods within the cycle is equally crucial as managers have different styles and alpha drivers and the ultimate goal is to identify managers which can be used as 'building blocks' to build a complementary, more stable, portfolio. Screening managers over relevant time periods rather than standard 3-year, 5-year or 'since inception' periods greatly enhances insights into true alpha capabilities and style characteristics.

Furthermore, classifying managers based on these styles or characteristics, in order to make more accurate peer group comparisons and to more accurately assess how managers in the peer group might meet the needs or fill in any gap in existing portfolios is fundamental.
For these portfolios to deliver stable outperformance over time, it is critical to understand the impact of risk factors across the stages of a cycle on a single manager's performance potential.

The ultimate goal for a well diversified portfolio is not just a diversification across asset classes but also a diversified sub-set of styles to reach complementary contributions to excess returns from the underlying managers over the whole cycle.

Figure 1: Diversified portfolio – equity risk factor exposures



Source: Corestone

While for example some of the implemented equity managers might be more vulnerable to a risk off scenario, higher quality managers in other regions or areas should offset this bias to balance the portfolio.

Adding a manager, while being best in class, with similar characteristics as the existing ones to such a portfolio setup might not necessarily improve the outcome but actually lead to the opposite result, that is less stable performance and a higher scenario vulnerability and inferior long term results.

Though balancing the portfolio on the asset class level is easier, taking a holistic portfolio approach across the equity and fixed income spectrum should also be considered as necessary and possible. As such, a diversification of risk factors between the equity and the fixed income portion of the portfolio, where for example some High Yield managers offset higher beta equity portfolios is desirable and enhances scenario resilience.

Diligent investors should put increasing emphasis on and resources in not only finding the best manager for a single asset class, but take total portfolio considerations into account to build long term stable and style neutral portfolios with complementary sources of returns across and within asset classes and across cycles.

Hence, sometimes, adding what might seem the second best, but more fitting manager to the portfolio should be your first choice to ensure satisfactory long term portfolio returns. «

- Simply combining best-in-class managers can lead to inferior results due to unintended structural portfolio biases.
- A holistic portfolio approach is necessary during the selection process.
- Complementarity for manager selections is key.
- Understanding of inflection points, styles and risk factors of all relevant asset classes is a prerequisite for successful manager selection.

This article was written by Dr. Cord Hinrichs, Head Asset Allocation at Corestone Investment Managers AG.