Multi-Asset Class Investing: Part 1 – Forces Behind a Trend

SUMMARY

Meradia has observed a strong uptick in activity around Multi-Asset Class (MAC) investment products and strategies. We see managers across the globe expanding current MAC offerings and introducing new ones; consequently, generating demand for new support around analytic methodologies, data and technology.

BACKGROUND

This series explores our view of the MAC phenomenon in depth, from origins to solutions. In this first of three installments, we look at market and industry trends that seem to be driving the evolution of MAC towards more sophisticated strategies and methods.

WHY DO WE NEED TO REVISIT MAC?

Good question – it's not as though strategies with more than one asset class haven't been attempted previously. Examples include "balanced" and "60/40" funds which have been around for as long as we can remember.

Furthermore, methods analyzing and attributing risk and performance to these portfolios don't – at first glance – seem to be lacking either. There are dozens of papers and articles that address the analysis of balanced stock and bond portfolios. Many more detail specific methods for multi-level attribution – an important requirement for MAC portfolios. Most vendors' performance platforms support at least some of these methods.

Yet, during the past three years, we've been helping more and more clients who are either bootstrapping new MAC strategies or designing and implementing methodologies in support of existing products. While the roster of MAC alternatives continues to grow at rapid pace, the current inventory of off-the-shelf tools designed to analyze these products doesn't seem to be cutting it any longer. It seems it's time to take a step back, look around, and see what's going on with this trend.

FLIGHT-TO-PASSIVE INVESTEMENT PUTS PRESSURE ON ACTIVE MANAGERS TO PROVE THEIR WORTH

As the New York Times writes, Vanguard is growing faster than everybody else combined. During the past three years, new inflow topped $832 billion, while the rest of the mutual fund industry – over 4,000 firms in all, only managed $97 billion. That's over 85 cents of every inflow.

Admittedly, Vanguard still does not run active products; almost 29% of their $4.2 trillion AUM are in active funds. Still there is not much joy in denying a trend of those kinds of numbers. Fees are being squeezed, and assets are declining. Active managers have been weighed, they have been measured, and they have been found wanting. In what world could they possibly beat the market?

PERCEPTIONS OF RISK MATURE: FROM FORBIDDEN TERRITORY TO VALUABLE INVESTMENT TOOL

MAC is all about finding and allocating to risky asset classes — as long as they're uncorrelated. Reducing whole portfolio volatility (in alignment with investor objectives) is, more and more frequently, becoming an intentional method of improving outcomes.

To this end, the inclusion in the portfolio of asset classes previously viewed as unacceptably risky is becoming more commonplace. Out-of-country and out-of-benchmark bets, derivatives, illiquid asset classes are all becoming better understood and utilized as tools for diversifying and controlling investment risk, and not the anathemata they were once considered previously.

PASSIVE PRESENTS A BUMPY ROAD TOWARD INVESTOR OBJECTIVES

As we've alluded before, a plethora of ETFs and index funds do not an allocation make. Passing off the single most crucial investment decision to the investor — who may have no more than a cursory acquaintance with correlation — is bound to result in some less-than-ideal outcomes.

Even in a managed context, it has become painfully obvious that passive allocation fails to meet basic investor objectives. The volatility of portfolios with static "strategic" allocations to major asset classes is unnecessarily high, and the drawdowns that result can be decimating. This insight is particularly relevant in the defined contribution space, where sequencing and longevity risk are dominant threats to investor objectives. As a result, active MAC management is becoming a beacon to those who realize they are approaching potentially rocky shores and is likely only to shine more brightly as these trends play out.

FRONT VS. MIDDLE OFFICE: A SHIFT IN THE BALANCE OF POWER

There was a time when portfolio managers could obtain just about any analytic they requested. If they said they needed an attribution system, somebody built one; if a risk model was an absolute must-have, then someone made it so.

During that era, vendor solutions for such analytics were non-existent, or at best very primitive. Over time, vendor systems matured and became more full-featured; implementing one; however, incurred a high overhead in terms of operational data and technology management. The middle office came into being, growing in size and responsibility over time to shoulder these burdens.

The front office found their influence in the selection, implementation, and enhancement of these and other applications to have waned. Middle office "solutions" became entrenched and focused more toward client reporting and GIP than on granular analysis. As their needs changed and grew, portfolio managers adopted the DIY approach: we'll just download returns and contributions and build what we need in Excel and Access.

As one would imagine, this approach was destined to have a finite limit of feasibility. Spaghetti-linked spreadsheets — with undocumented macros and embedded SQL queries to ad-hoc tables — cannot scale. As new accounts, mandates, strategies and products were added to the management mix, the structure of the process became overwhelmed, threatening to eventually crash under its own weight.

In the MAC world, perhaps; it might just be the last bastion wherein active fees can reasonably be justified. Look at these characteristics which all recommend active MAC management:

- It's differentiable* – Most people think of "active management" and equate it with "stock picking." Asset selection may or may not be exercised within specific classes of a MAC strategy; nevertheless, class allocation is by far the strongest part of its appeal. *Not a calculus joke.
- It carries greater impact – Asset allocation has been shown, repeatedly, to be by far the largest contributor to portfolio performance.
- It's not easy – As Greg Cooper of Schroders cogently points out, passive allocation doesn't cut it. Active allocation requires a deep understanding of risk and correlation, more than most asset owners can muster.
- It's a compass in the jungle of passive options. Passive investing sounds simple; yet, with thousands of ETFs and index funds available – more indices than stocks – how can the asset owner hope to make an allocation decision without informed guidance?
- No Global MAC bench exists. For example, there is no investible passive alternative for a GMAC strategy – by definition, it's an active process.

However, there are some people looking to remediate that situation . . .

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GLOBAL ASSET CLASS BENCHMARKING TAKES ITS FIRST STEPS

A published GMAC benchmark would be intrinsically attractive to both managers and owners. Recent research into the weights, returns, and contributions of such an index, by asset class, has made substantial progress toward this goal. As demand for MAC strategies grows, we expect to see commensurate development on the benchmark side of the attribution equation.

Moreover, these DIY analytics were producing performance results that differed from the book of record. Free from settlement, valuation or audit constraints, it is hardly surprising that front office performance, based on an investment view, would differ materially from middle office accounting view results. As managers we are often asked to supply their custom attributions for bespoke RFPs, chaos naturally ensued.

Perhaps it is a coincidence of historical timing, perhaps a function of its challenging and complex analytical requirements; whatever the cause, MAC looks to be a force that is changing and dynamic. Whatever substantial investment is being made in MAC products and strategies, it becomes increasingly obvious that neither skunkworks spreadsheets nor existing middle office infrastructure can support the process necessary to keep that machine running reliably and accurately.

CONCLUSION

For a number of reasons including market pressures, industry maturation, historical legacy; it appears MAC – global MAC in particular – are maturing into sophisticated strategies for enhancing the active return/risk proposition. It also seems abundantly clear that new methodologies, data and technology approaches need to be designed and developed to measure, analyze, and attribute performance and risk to the MAC investment process. Why, you ask? Tune in to Part 2 of this series:

"Multi-Asset Class Investing: What do we do Differently?"

MAC is not only here to stay, it's growing and evolving. How will that impact you? How are active MAC managers different from the rest? We've already got active managers, and an abundancy of methodology, data and technology supporting them. Will those tools work for MAC equally well?

Mark R. David, CFA, Director of Performance, Risk & Analytics,
and his team of subject matter experts begin by working with front office practitioners: eliciting, informing, and refining their business requirements to obtain consensus on a detailed analytic solution. They then pivot to providing and managing the hands-on implementation team – operations, data stewardship, vendors and IT – bringing the client's business vision to reality at the highest standards of quality.

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