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The Merits of Multi-Manager Structures

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Snapshot

- Manager-of-managers strategies combine multiple third-party manager strategies into a single mutual fund with the expectation that specialization should have a beneficial bearing on performance.
- A substantial difference exists between multi-manager strategies and the fund-of-funds model; a fund-of-funds invests in other commingled funds, which is distinct from the direct hiring of third-party sub-advisors.
- SEI believes the multi-manager structure offers advantages relative to funds-of-funds in terms of the universe of potential sub-advisors, monitoring discretion, and re-allocation processes.

Mutual funds offer investors professional management—that is, investors benefit from the decision-making and monitoring of seasoned investment experts. For many investors, this represents a superior alternative compared to making decisions on their own.

The traditional mutual fund structure focuses on a specific asset class, like large-cap U.S. stocks or developed-market government bonds, for example. This relatively narrow emphasis enables investment professionals to focus their research and expertise with the rationale that they should be able to produce better results through specialization.

Multi-manager or manager-of-managers strategies combine several strategies run by different third-party managers into a single mutual fund for the same fundamental reason: specialization should be expected to have a beneficial bearing on performance.

A substantial difference exists between multi-manager strategies and the fund-of-funds model; both have a top-level fund structure, but a fund-of-funds invests in other commingled funds, which is distinct from the direct hiring of third-party sub-advisors.

Swimming in Different Pools

The universe of potential sub-advisors is considerably larger for the multi-manager structure. Funds-of-funds are limited by the cross-section of registered mutual funds, while multi-manager strategies can consider many of the same managers that operate these fund strategies as well as institutional investment managers that don't offer mutual funds.

The nature of the relationship between a manager-of-managers and its sub-advisors creates pricing power in fee negotiations that simply does not exist with take-it-or-leave-it fund pricing. Leverage resides with the manager-of-managers, who presumably represents an appealing potential investor for sub-advisors given its large asset base and long time horizon.

A Helping (but Steady and Firm) Hand

The multi-manager structure facilitates a strong measure of oversight to ensure underlying strategies fulfil their mandates that is unavailable to funds-of-funds.

Multi-managers are able to evaluate potential sub-advisors before hiring them to gain deep insight on everything from their philosophies and processes to their operational and risk management controls. This provides an opportunity to monitor and measure their contributions to risk, return, and general adherence to performance expectations through different stages of the cycle.

All of this—while not necessarily unique to hiring sub-advisors directly in comparison to investing in a commingled fund—nevertheless supports ongoing monitoring that can identify breaks in a sub-advisor's processes. At this point, a manager-of-managers can highlight, question, and demand changes as the sole client of an individual mandate. A fund-of-fund's recourse is limited to exiting the underlying fund investment, which raises potentially expensive implications.

The Comparative Costs of Friction

Underlying sub-advisors (in the multi-manager construct) or funds (in funds-of-funds) will eventually experience turnover, perhaps as differences become irreconcilable, but even for reasons as mundane as capacity constraints.

This turnover is handled much more efficiently by the multi-manager structure. The hiring or termination of a sub-advisor occurs within the top-level fund and does not require the immediate sale of a terminated sub-advisor's entire portfolio since the securities are held directly by the fund. The replacement of an underlying fund within a fund-of-funds, meanwhile, requires liquidation to cash and purchase of a new fund, which may create a taxable event.

Underlying allocations can also be expected to shift gradually over time as the market cycle progresses and fundamental conditions change. These weighting changes can be enacted more cost-effectively in a multi-manager structure for the same reasons as hires and terminations.

Finally, the multi-manager structure's avoidance of commingled funds means it is not subject to the transactional expenses triggered by other investors' decisions to enter and exit the underlying funds, and can steer clear of pricing that must accommodate two full layers of registered fund administration costs. The manager-of-managers construct has its own fee structure, which potential investors should review and understand.

SEI's View

Despite its drawbacks, we see value in the fund-of-funds structure, and believe it's best-suited to fulfil a high level allocation role in constructing a complete portfolio rather than an asset-class-specific strategy.

In addition to the merits we've already detailed, we believe the multi-manager structure is well-suited to support systematic beta and factor exposure strategies in some asset classes as a component of the overall strategy. This creates an opportunity to deliver these types of strategies at competitive costs, which preserves resources for hiring sub-advisors with demonstrable skill and track records of alpha generation.

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