Diversification at every level: reducing ‘star manager’ risk in your portfolios

No doubt the most significant story in the news over the last few days has been around the total eclipse that spanned a thin strip of the United States of America. Millions flocked to the totality’s path to witness the first total solar eclipse of the contiguous United States since 1979. But this wasn’t the only news of a celestial nature to make headlines this year; a number of ‘star’ fund managers have seen the light go out in pretty painful fashion.

Massive benchmark-relative overweights to the shares of embattled companies have seen, in some instances, significant performance hits for funds that have hurt their overall performance for the year so far.

Whilst superstar individuals often make for good stories in fund management folklore, the reality of month-in-month-out long-term performance is rarely as compelling; “the aggregation of marginal gains” doesn’t sound as sexy as “shooting the moon.”

This is why we advocate a multi-manager approach to investing; another layer of diversification within your portfolio that reduces overarching key man risk. We believe that by allocating managers to strict mandates, dictated by what we feel their competitive advantage is, there is no human bias towards achieving or maintaining stardom.

SEI’s manager selection process applies a first instance quantitative screen to analyse a universe of as many as a 100,000 specialist investment managers, teams and products. This stage includes examination of each manager’s process to deliver alpha, analysing their risk and return metrics and making assessments on each manager’s ability to consistently exploit alpha sources.

Once this pool is narrowed down to a number of managers suitable for SEI's funds, they are added to our database of around 3,000 managers on whom we perform ongoing fundamental due diligence. This fundamental analysis goes deeper, analysing their historical securities holdings, examining the characteristics of the portfolios they build, looking at the quality of their track records and making assessment on their risk management abilities.

As part of maintaining this database, we also perform ongoing qualitative analysis on managers. This includes engaging in over 1,000 contact points a year; these can be on-site visits or conference calls and allow our team of manager researchers to get a complete understanding of each manager's process, reasoning for decisions and make informed judgements on whether or not to hire the manager. This is a crucial part of the process because it affords our manager researchers the opportunity to see the whites of each manager's eyes and make their assessments face-to-face.

The ongoing monitoring aspect of our manager research means that we continuously maintain a dialogue with managers – even if they are not currently managing money in an SEI portfolio. This allows us to stay abreast of their latest thinking, perform competitive analysis on their performance and monitor their risk controls and personnel changes to inform any future decisions we make to appoint or terminate the manager.

Ultimately, performance is rarely the deciding factor in the decision to appoint or terminate an investment manager. It makes more sense to make such decisions based on broader market observations as these allow us to allocate managers based on which mandates have the greater probability of providing the best risk-adjusted returns within a portfolio.

Recent examples of this can be seen within the US Large Cap equity portions of our Strategic Portfolios, where we took the decision to remove the managers Brown Advisory and Waddell & Reed whose styles we believed were no longer favourable given peaky valuations in the US equity markets. We decided to replace them with managers Coho Partners and Fiera Capital Corporation – two managers whose styles we believe would be better able to produce superior risk-adjusted returns in such conditions.

Similarly, we took the decision to remove Fiera and Jennison Associates from our Global Equity allocations within our Strategic Portfolios as we felt that their styles were no longer complimentary to the fund's overall positioning. As a result, we replaced them with Danish asset manager Fondsmaeglerselskabet Maj Invest (Maj Invest), whose preference for avoiding high downside risk and exploiting inefficiencies in investment markets make them a better fit.

These complimentary blends of managers and the active management of those blends helps to reduce overall risk of overexposure to any particular securities or individual managers, helping contribute to a smoother investment experience over time. It doesn't generate the legendary stories of managerial moon shots, but equally can help mitigate the not-so-heroic episodes of being fed a dummy by the markets. And whilst we in the UK won't see a total solar eclipse until 2090, it's a pretty safe bet to say that investment markets will go dark a few times between now and then.

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