HOW CAN WEALTH MANAGEMENT FIRMS BENEFIT FROM MULTI-MANAGER STRATEGIES?

MERCER

EXECUTIVE SUMMARY

Financial intermediaries face a variety of challenges in today's marketplace, including:

- Preparing portfolios for an expected low-return environment
- Simplifying and diversifying investments while meeting clients' complex needs
- Optimizing governance structures to improve operational efficiency

Multi-manager portfolios can help with these challenges, as they provide assistance with:

- Tax and capacity management
- Access to lower-fee institutional share classes
- Access to capacity-constrained alternative investments — at times, with increased transparency

Transitioning to a multi-manager portfolio structure takes time and due diligence in order to identify firms with strong offerings that allow the intermediary to better serve its clients.

ENHANCING LINE-UPS WITH MULTI-MANAGER PORTFOLIOS

Based on our work with financial intermediaries, Mercer identified a few key areas for wealth management firms to help their clients. Multi-manager portfolio solutions can help address these areas with the goal of improving client outcomes. At the same time, this portfolio solution allows advisors to spend more time serving their clients and developing new business.

Areas of consideration	Addressed by multi-manager portfolio solutions?
Combating low return expectations	✓
Simplifying and diversifying	✓
Optimizing governance structure	✓

COMBATING LOW RETURN EXPECTATIONS

Optimal portfolio construction seeks opportunities to simultaneously maximize returns while protecting against potential market downturns. Multi-manager portfolio solutions use three levers to improve outcomes.

SEEKING OPTIMAL STRATEGY ALLOCATION

Multi-manager portfolios can help to optimize the allocation to asset classes and strategies. In addition, the managers are in a position to determine when it is best to invest in index funds to save on costs and when active management can contribute alpha. Increased access and allocations to alternative investments may also improve risk-adjusted outcomes.

REDUCING TRANSACTIONS COSTS, TAXES AND FEES

Using a multi-manager portfolio that incorporates transition management for rebalancing and subadvisor changes can increase after-tax returns, primarily by minimizing turnover during transitions. Further, multi-manager separate account portfolios allow for the use of tax-minimization strategies. Replacing a subadvisor within a multi-manager portfolio removes the tax consideration issue that often delays implementation of single manager changes.

Multi-manager portfolio solutions can often result in lower investment manager fees, as the manager of managers can negotiate lower fees for combined assets than the financial advisor could negotiate on its own.

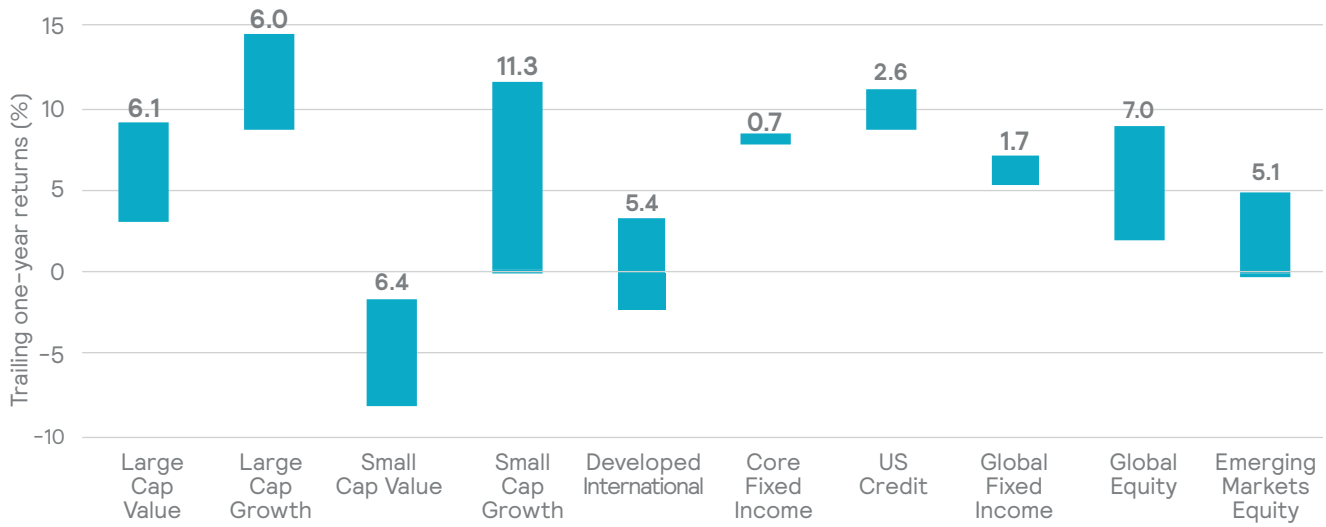
ADDING ALPHA

To illustrate the importance of manager selection, the performance highlighted in Exhibit 1 below shows that in the trailing 12 months ending June 30, 2019, the dispersion of returns between the top and bottom quartile of active managers was significant across major equity universes, most fixed income universes and the hedge fund universes (also see Exhibit 2). The largest dispersion was in small cap growth, where the difference was more than 11%, while the dispersion in three hedge fund categories was also greater than 11%. Selecting top-performing managers can add value to portfolios.

In addition, multi-manager solutions can provide access to top-performing but capacity-constrained managers not available otherwise.

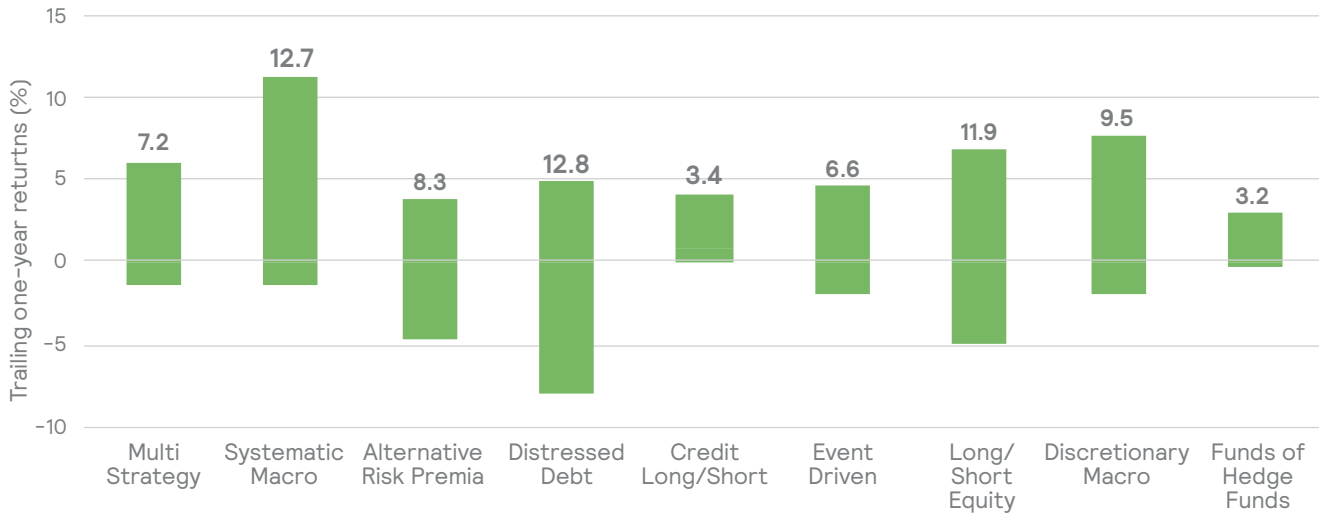
> Alpha diversification needs to be optimized. That is, investors must look to diversify the alpha source across managers within asset classes.

Exhibit 1: Dispersion of Returns Between Top and Bottom Quartile of Traditional Long-Only Active Managers



Trailing one-year dispersion as of June 30, 2019 (top 25th percentile to bottom 25th percentile of managers)
Source: MercerInsight® — for illustrative purposes only.
[1] Refers to the period of economic crisis between mid-2007 and early 2009.

Exhibit 2: Dispersion of Returns Between Top and Bottom Quartile of Hedge Fund Managers



Trailing one-year return dispersion as of June 30, 2019 (top 25th percentile to bottom 25th percentile of managers)
Source: MercerInsight® — for illustrative purposes only.

The large dispersion among hedge funds provides potential opportunities for multi-manager programs. However, in the years immediately following the global financial crisis, interest in diversified multi-manager hedge fund portfolios diminished as investors sought to lower costs. Additionally, other investors liquidated their hedge fund portfolios in favor of better-performing long-only equities. Taking this into consideration in conjunction with a lower expected return environment for traditional assets and lower fees for diversified programs, investors are increasingly returning to these constructs.

SIMPLIFYING AND DIVERSIFYING

Financial advisors face many challenges in building client portfolios — finding differentiated active managers, monitoring and replacing underperforming managers, managing tax impacts and monitoring trades, to name a few.

REDUCED RESOURCE NEEDS

Multi-manager solutions reduce the resources needed to research investment strategies and the dedicated resources to research a universe of managers within each strategy.

To properly research the advisability of investing in certain asset classes and investment strategies requires significant research resources: experts on numerous strategies, portfolio construction skill, and risk management skill and platforms. In addition, resources need to be allocated to manager research and selection as well as oversight and monitoring.

Multi-manager portfolios streamline financial advisory firms' resource needs, as firms need only select and monitor the multi-manager advisor.

DIVERSIFICATION OF SINGLE MANAGER RISK

Good portfolio construction seeks to optimize alpha diversification and mitigate single-manager risk. The net result should be a well-diversified portfolio of complementary strategies and managers — combined in a way that increases return potential while reducing risk.

LIMITED NEED FOR OPERATIONAL PLATFORMS

There are numerous ongoing operations needed to run multi-manager portfolios — custody, trading, settlements, rebalancing needs, performance measurement, etc. The multi-manager advisor handles all of this, reducing the need for the financial advisor to invest in these resources and monitor them over time to assure best-in-class safeguards, fees and experience.

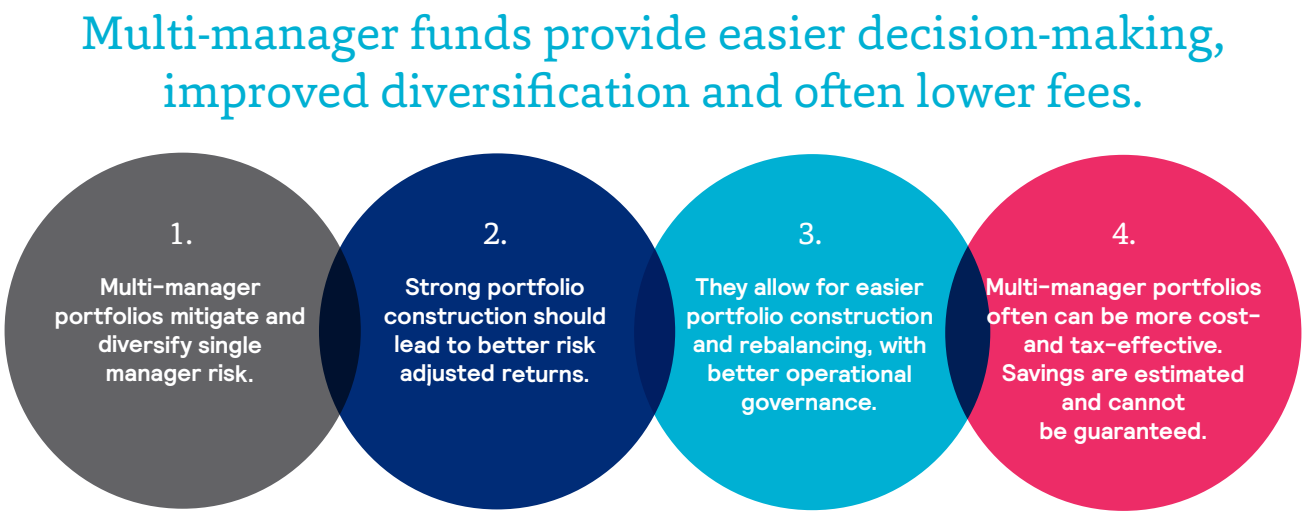
OPTIMIZING GOVERNANCE STRUCTURE

Choosing a multi-manager solution streamlines and often improves the governance structure for financial advisors. The multi-manager is responsible for:

- Researching and documenting allocations to asset classes and investment strategies
- Researching and documenting allocations to investment managers
- Documenting the monitoring of the allocations and managers on a regular basis
- Documenting and implementing asset allocation changes, manager changes and rebalancing
- Providing regular performance and risk reporting along with commentary

The financial advisor need only monitor the single multi-manager of managers over time, documenting decisions related to the initial and ongoing retention of the manager. Fiduciary responsibilities related to portfolio construction and monitoring are greatly reduced.

Exhibit 4: Governance and Implementation Process



HOW CAN CLIENTS BENEFIT?

Multi-manager strategies can add value for financial intermediaries in the following ways:

Flexibility

- Choice of subadvisors not limited to '40 Act products
- Tax-management — can employ transition management, tax-loss harvesting, etc.
- Capacity management

Communication

- Increased transparency
- Combined reporting

Fees[2]

- Greater negotiating power/potentially lower fees due to asset aggregation at the advisor level
- Lower operational costs

Portfolio construction (see details in the appendix)

- Client account aggregation — typically leads to better access to institutional share classes and alternative investments
- Ability to use higher active share managers that can be blended together for an improved information ratio
- Style factor diversification
- Customized exposures

Governance (see details in the appendix)

- Simplified decision-making process to focus on asset allocation
- Simplified rebalancing
- Simplified asset allocation change implementation
- Delegated fund selection/governance to a qualified third party
- Operational due diligence provided by multi-manager advisor
- Reduction in business risk compared to single-manager portfolio

[2] Savings are estimated and cannot be guaranteed.

CONCLUSION

Across traditional long-only and alternative asset classes, advisors have an opportunity to leverage multi-manager portfolios to enhance risk-adjusted returns for their clients while improving the marketability of their portfolios and reducing the administrative burden.

Multi-manager portfolios provide a unique opportunity to optimize the diversification of client portfolios toward better outcomes.

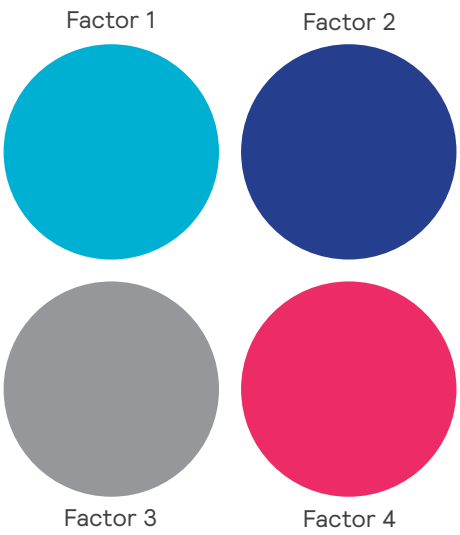
Beyond diversification, the strategies may provide lower fees, access to well-regarded managers, tax minimization and an improved communication, documentation and governance structure.

APPENDIX

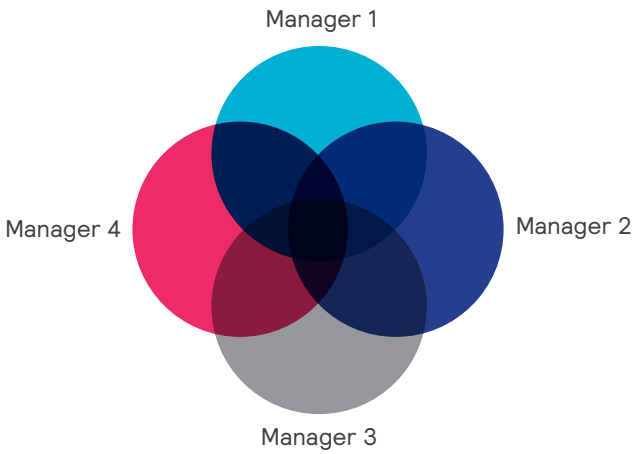
A. Manager Selection and Portfolio Construction

Multi-manager portfolio advisors must have a robust list of subadvisors to choose from when making manager selections for the portfolio. From this universe, a small group of complementary, high-quality managers can be selected by optimizing factor exposures that fit clients' objectives. A portfolio of complementary managers is built to generate competitive returns in various market environments based on factor analysis and how each manager invests assets. This process ensures that the managers fit together and increases the potential for performance to be in line with investment objectives and risk constraints.

Desired Factor Exposure



Desired Factor Exposure Using Complementary Managers in a Multi-Manager Portfolio



Once the portfolio has been thoughtfully constructed, each underlying manager must be monitored to ensure that allocation shifts or manager changes can be executed in a timely fashion. Detailed manager assessments should be made on an ongoing and individual basis, where each manager is assessed based on its style and philosophy. Additionally, the manager should be evaluated based on its contributions to the targeted overall portfolio characteristics. Scenario analysis tools can be used to assess the portfolio under different market environments, as manager return behavior changes based on market conditions, especially in times of crisis. Perspective from these scenario outcomes can lead to changes that improve risk-adjusted returns during various market periods.

B. Ongoing Three-Phase Cycle

Multi-manager structure and maintenance cycles include: 1) research, 2) manager selection and 3) monitoring, rebalancing and replacement.

- **Manager selection**
  Select managers who have complementary strategies.
- **Monitoring, rebalancing and replacement**
  Oversee underlying investment managers, and replace those that underperform or deviate from their stated strategy.
- **Research**
  Develop and analyze a robust list of managers, both qualitatively and quantitatively.

The differentiating factors between multi- and single-manager portfolios range from alpha diversification to control over branding of strategy.

Summary of Enhancements of Single- Versus Multi-Manager Portfolios

	Single-manager portfolio	Multi-manager portfolio
Alpha diversification	Not possible	Possible
Portfolio construction	Single-focus	Complementary
Flexibility in timing taxable gains/losses	Low	High
Operational flexibility	Low	High
Burden of subadvisor change	High	Low
Ability for advisor to manage portfolio branding	Low	High
Ability to streamline oversight	Low	High

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