Portfolio Matters

Losing at the Singles Game
– Investors with only one equity manager are most likely to underperform

Many investors believe in active management, but most are doing it incorrectly. Find out why we believe that only having a single active manager is expected to detract value and what actions investors can take to improve their chances of success.

There are many reasons why investors are not getting the most out of their active portfolios. This could be due to having a large home-bias, imposing constraints or not letting their active managers take enough risk. However, the most common mistake we have observed from institutional investors is the lack of diversification in their manager line-up. Among our Asian clients investing in equities, one in every five clients use only one active manager. Half have no more than three active managers.

What's wrong with having just one active manager in your equity portfolio?

1. The majority of actively managed funds have been unable to outperform after fees*

   According to various studies, if you only pick one equity manager, then the chances of them adding value is pretty low. One study in particular shows that based on a rolling 10 year average, less than 20% of funds were able to outperform their benchmarks on net of fees basis* .

   Less than 20% of funds were able to outperform their benchmarks

   To increase the odds of success, we believe asset owners should undertake detailed due diligence and qualitative research. However, even with our extensive resources and leading manager research process, we estimate a single top rated manager will have a 65% chance of outperforming their respective benchmarks.

2. Significant stakeholder pressure to act when the manager goes through the inevitable periods of underperformance

   No matter how good an active manager is, they will go through performance cycles and inevitably underperform for a period of time. This could be due to a result of a wrong stock picking decision or due to their particular style (growth/value, size, or quality) going through a period of underperformance. Whilst this may not be an issue for investors who are truly long-term oriented, many institutional investors oftentimes do not have the ability to tolerate shorter term underperformance due to stakeholder pressure.

   As a result, they spend a lot of time and energy questioning performance, making poor hiring and firing decisions based on short-term performance. These decisions often detract value over time.

   One may argue investors can opt for a "core" type mandate which is more diversified, in order to avoid prolonged periods of underperformance. This however means paying active management fees, with little chance of outperformance. It is our view that investors should expect such mandates to underperform after fees.

* Source: S&P Dow Jones Indices LLC, CRSP. Data as of December 31, 2015. Outperformance is based upon equal weighted fund counts. All index returns used are total returns. In a separate study of the eVestment database, we found the proportion of outperforming managers to be less than 25%.

Figure 1 summarises the issues faced by investors using a single manager portfolio, while *Figure 2* provides an illustration on how investors can detract value in making poor hiring and firing decisions.

Figure 1. **Single manager portfolio**

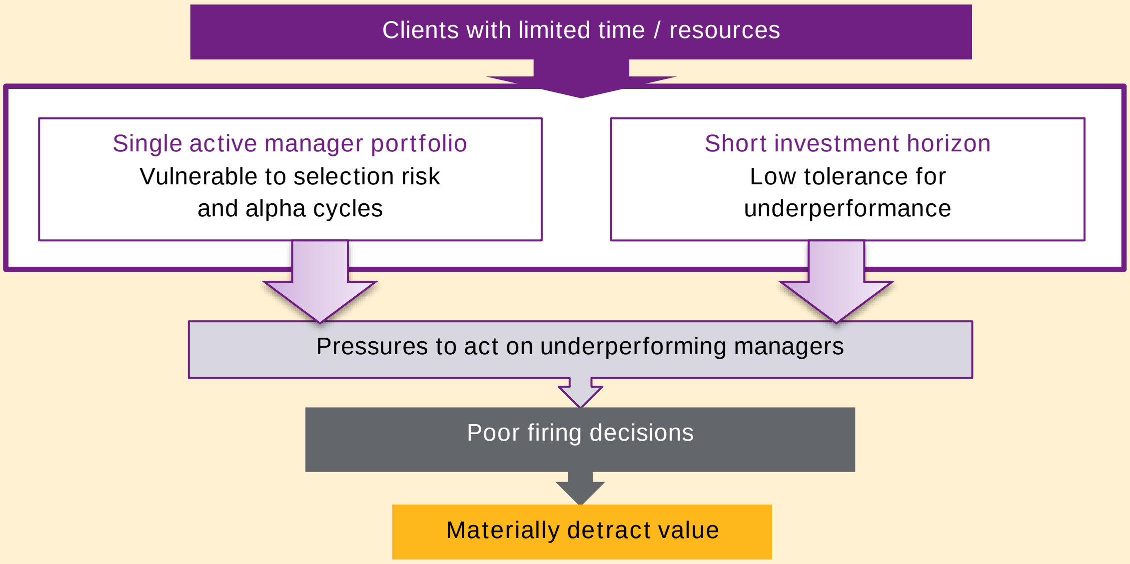
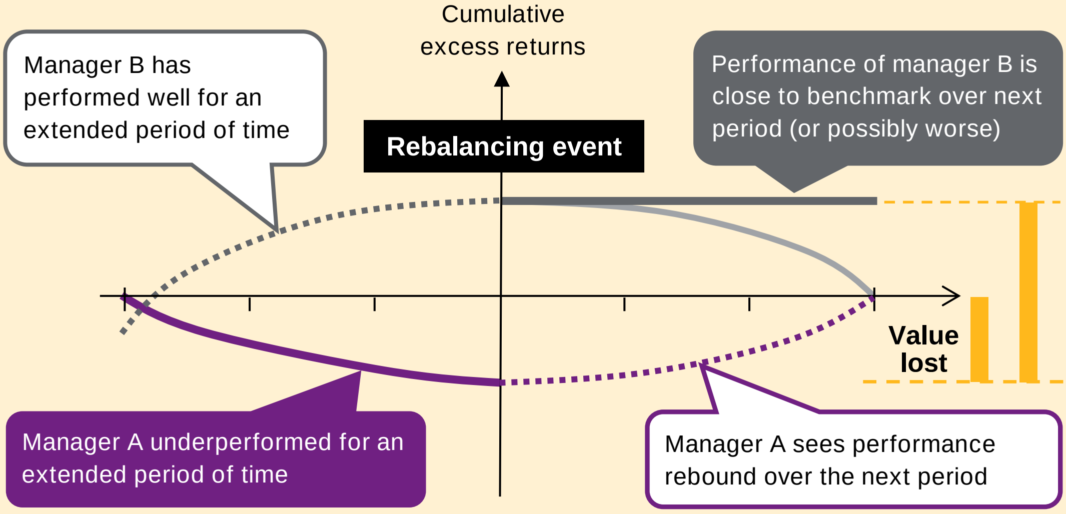


Figure 2. **hiring and firing**



Source: Adapted from Goyal and Wahal, The Journal of Finance, August 2008.

What are you going to do: 'Simplify', or 'Raise Your Game'?

Simplify – Use single-manager passive portfolio

A single-manager passive portfolio strategy reduces costs and frees up governance budget for other investments related matters, which are more strategic and impactful in nature. One example might be to allocate this time and energy towards building a portfolio with greater diversity through exposure to new asset classes and strategies, which are less sensitive to equity markets and rising interest rates.

A passive strategy will also be expected to outperform most single-manager portfolios over the long-term. As noted earlier, less than 20% of active managers actually outperform their benchmark after fees. Clearly, using a passive manager means walking away from the potential for alpha to increase portfolio returns, which is considered very attractive in the current low expected return / low yield environment, and stakeholders need to be willing to accept this. However, this would only be an issue where there is a desire or need for higher returns, and a shared investment belief in active management.

Raise Your Game – Build a better, multi-manager active structure

For those who choose to stick with their belief in active management, we recommend building a multi-manager active portfolio. Selecting complementary managers mitigates any potential style biases or market cycle impacts (whilst a single style might underperform, the chances of different styles underperforming at the same time are very small).

Relative to both a passive and single manager portfolio approach, we believe this structure improves portfolio efficiency and has a very good chance of delivering valuable alpha to investors.

In our view, a well-constructed multi-manager, high active share portfolio can add over 2% p.a. of additional return with limited amount of increased risk.

Figure 3 (below) shows the 5-year annualised returns of portfolios with different numbers of our top-rated unconstrained global equity managers. It demonstrates that the larger the number of our top-rated managers in the portfolio, the less volatile the returns will be.

However, constructing and managing a multi-manager portfolio is complex. It requires significant time and effort to research and select the best managers, as well as build and implement the portfolio. Once the portfolio is created there are then more managers to monitor and evaluate, and portfolio rebalancing becomes more challenging.

In the past such complexity has resulted in many investors opting for a single manager portfolio and only investors with large teams have been able to adopt a multi-manager approach. This is no longer the case.

Developments in the market to allow more investors to 'raise their game'

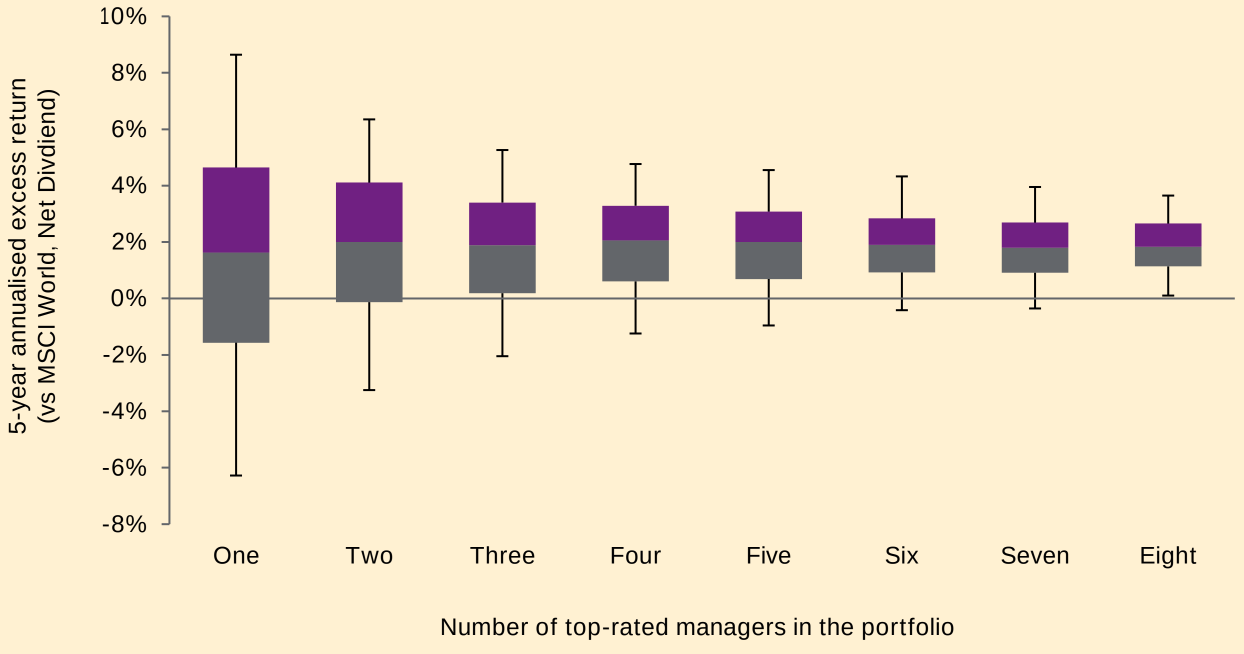
Over more recent years, we are seeing an increase in multi-manager solutions, which enable investors to gain access to a pool of active managers. These solutions are provided by professional third-party vendors, with the requisite time, expertise, and operational know-how in building and managing multi-manager portfolios.

This means that institutional investors can now effectively use this new avenue to raise their game and access better alpha, without an increase in complexity compared to their current structure.

The best part is that such structures, backed with sufficient scale and bargaining power have the ability to offer very attractive fee arrangements to institutional investors – meaning that total costs are often similar to existing investment arrangements.

In our view, a well-constructed multi-manager, high active share portfolio can add over 2% p.a. of additional return with limited amount of increased risk.

Figure 3. Portfolio of unconstrained top-rated global equity managers (rated by Willis Towers Watson)



Conclusion: reconsidering the manager line-up

We have outlined some of the challenges investors face when having only one active equity manager in their portfolio. Specifically, we note:

1. Most active managers are expected to underperform, after fees.
2. Investors are at risk of making poor hiring and firing decisions which detracts value.
3. We recommend investors either simplify (i.e. go passive) or raise their game (diversify their active manager exposure).
4. A well-constructed multi-manager, high active share portfolio can add over 2% per annum of additional return with limited amount of increased risk.
5. Investors can now access multi-manager solutions to access better alpha without an increase in complexity.

About Advisory Portfolio Group – Asia

Willis Towers Watson has a series of Advisory Portfolio Groups (APG) within the Investment line of business around the globe, based in the Americas, Asia, Australia, the UK and EMEA. The APG in Asia seeks to identify and develop best ideas and approaches that can offer a competitive advantage to Asian institutional investors, while spearheading Asian-focused investment research and portfolio construction advice. Further, the group is responsible for ensuring high quality and consistency of advice, and works with client teams to design portfolios according to each client's risk and return preferences.

This paper was written by members of the APG for general information purposes only.

Produced by:
Vincent Lau
Senior Investment Analyst

Reviewed for APG by:
Will Rainey
Head of Strategy, Asia

Further information

For further information on this topic, please contact your usual Willis Towers Watson consultant or email

investment.solutions.asia@willistowerswatson.com

About Willis Towers Watson

Willis Towers Watson (NASDAQ: WLTW) is a leading global advisory, broking and solutions company that helps clients around the world turn risk into a path for growth. With roots dating to 1828, Willis Towers Watson has 40,000 employees serving more than 140 territories. We design and deliver solutions that manage risk, optimize benefits, cultivate talent, and expand the power of capital to protect and strengthen institutions and individuals. Our unique perspective allows us to see the critical intersections between talent, assets and ideas – the dynamic formula that drives business performance. Together, we unlock potential. Learn more at willistowerswatson.com.

WTW-INV-AP-2017-1011 October 2017