Learning outcomes: 1. How due diligence and fund manager selection operate in a multi-asset portfolio 2. How fund groups look to provide ongoing monitoring and assessment of mandates 3. The importance of meeting client objectives PRESENTER: Andy, we hear a lot that asset allocation is the core of pretty much all risk and return, so how important is manager selection and manager oversight? ANDY BROWN: Well once you've decided where to put your assets you do need to find someone to manage those assets in that local environment, bonds or equities, whatever that happens to be around the world. Making sure you get the right group or the right individual or the right team who can access the opportunity that you've discovered is hugely important. It can be extra source of manager alpha, making sure that you've got the right person at the right time. PRESENTER: And what sort of range of resources do you need to do something like that? ANDY BROWN: I think manager oversight is broken up really into two areas: one is investment oversight of due diligence and one is I guess the operational part of it. And both are equally as important. To take I guess probably the simpler one, the operational oversight first, you're really looking for the manager to be able to provide the resources, staff and systems to engage in the investment activity that you're asking them to do for you, and ensure that it's robust enough to be able to identify risks and so on as they occur. And on the investment due diligence side you're looking at the manager's ability to take advantage of the opportunities that you may have seen, or to keep most of the value at times when opportunities don't necessarily exist. PRESENTER: But when you're putting, take a step back when you put your multi-asset fund together for the first time, presumably you have to work out what its objectives are. ANDY BROWN: Yes. PRESENTER: Because that will inform why you select underlying managers. So could you talk us through that process and what should an adviser be keeping an eye out for? ANDY BROWN: The big ones that we use in our industry today are outcome orientated. And I think if we take it down a level and we say that I guess the best return a client can expect to get is the one they expect to get. And as an adviser you're very clear, far closer to the client than an asset manager could ever be. And you should be able to understand the type of outcome they want, whether that be income in a pensions freedom world, or whether that be growth in the run up to their opportunity to take part in pensions freedom. So the objective that you set in your portfolio has to meet that client's objective. There has to be I guess that suitability mix to come together, whether it be from a risk or whether it be from the return perspective. As the asset manager one has to ensure that each of the component parts of the portfolio are working together to produce that return and are not working against each other. And that can be a very difficult mix to achieve, because in normal circumstances one would expect risk assets to go up, normal assets to go down or vice versa. Ensuring you get the mix right produces that optimal return for the client within the risk boundaries that they would normally ask to receive. PRESENTER: Well just turning to the Pru by way of an example here, I mean from your point of view are you down to the level of thinking about what level of pounds, shillings and pence your investors get from each part of the multi-asset pot? How do you think about it? ANDY BROWN: In some cases it is down to the amount of cash that's generated. I think there are investors who will define their outcome as £500 per month. Some investors will define their outcome as a percentage return, and some investors might define their outcome as don't lose me my money, because the money's not designed to produce growth for them or income for them, but maybe an inheritance for their kids. And just those three very simple outcomes can lead to very different portfolios with very different constituent parts. And ensuring that your, I guess, single investment process can deal with those multiple outcomes is really important. PRESENTER: Well we mentioned a little earlier that the conventional view is that asset allocation is still incredibly important. Well firstly would you go along with that, is that where the core of risk and return comes from? ANDY BROWN: Yes, being in the right assets at the right time will always deliver you the best return. There's one part that tends not to be mentioned and that is time. Getting your asset allocation correct, and then leaving it long enough for the markets to weave their magic, and for the benefits of compounding interest to perform its magic on your portfolio is really important. And there are times when you would sit there and think well this is my central asset allocation position. And that's going to be like that for maybe five, 10, 15, 20 years. A lot of investors' horizons have suddenly over the course of the last two years stretched from five, six, seven years to 10, 20, 30 years, because they need to draw their income from their portfolio. So getting the asset shape at the outset is hugely important. And also being prepared to invest and wait for long enough for the benefits to appear in your own bank account. PRESENTER: And when you're talking about taking that long-term view, is that partly so that, because if you're banging around all over the place it's the trading costs that kill you, or is it because if you've got a strategic vision you've got to stick with it? ANDY BROWN: It's the strategic vision you've got to stick with. I think banging your portfolio around all over the place to use your phrase, that can happen in times when you have, there's a lot of stress in the market. I think back perhaps during the global financial crisis, and probably turnover in a lot of funds increased dramatically as fund managers attempted to hold onto the gains it made previously. There's no real benefit to an investor if they take a long-term investment horizon, and the last two or three years we suffer another 2008 or 2009, and suddenly all the good work that's been done for the previous eight years has disappeared. So there are times when you would want to adopt a more defensive approach to your asset allocation or to your stock selection, and other times you'd be more happy to take, I guess, a slightly more passive approach and let the markets weave their magic. PRESENTER: Well you mentioned passives there, given how big the market for passives now, what's the role of active managers in fund selection? ANDY BROWN: I think it's quite important to consider what passive and active assets or funds are doing. From our perspective I have neither a view of passive or active. I believe that they do different things at different times. On the passive side it means I can get very cheap and efficient implementation of the strategy. So if I think about a developed market, the UK or the US or Europe, it can be easier to buy a passive, an index approach to those markets; albeit that comes with risks. The S&P 500 is not the US; it's pretty much a technology index to be honest with you. PRESENTER: Yes. ANDY BROWN: Maybe something like the Wiltshire 5000 would be more representative, much harder index to go out and buy. Equally at times when the market is probably more stressed, I think at the moment we're in a really unusual scenario where the world seems uncertain, bond yields tend to fall to the floor, they go low as people buy bonds to protect their portfolios. And in times of greater certainty risk assets, equities go high, because people feel that good times are still to come. We're in a world where equity valuations are higher and bond yields are low. So at this point in time adopting a passive approach to allocation could lead you into a very difficult situation in the next two or three years. I think that's where active management will come to the fore, and we'll be able to see managers decide which parts of the market to avoid, which parts of the market are more sensitive to some of the economic information that comes through now. So you should be able to weave active and passive styles together. There is a cost argument to passive, and there's equally a value, keeping of value argument to active. PRESENTER: How does the rise of factor investing and so forth, smart beta affect that, because that's a rule systems based approach that could, you could access, tilts you towards value at the right time, but you're buying an index? ANDY BROWN: You are, and you're buying an index that you may well have been involved in constructing yourself. That index, that smart beta index may well represent your strategic asset allocation views. So smart beta or factor investing, whichever way you want to paint that particular can, is almost taking some of the more labour intensive and some of the more cost elements of active investment out. However I would still say that you do have to have a human approach to that, because you do have to understand the likely path of assets. It's true to say there's only one past but there are many futures. And helping to decide those futures, and therefore implement that strategy in an active format or in a passive way using a smart beta index is really important. And that's the active part of it that we can sometimes forget. We can sometimes just think that passive investing is just about replicating an index or a benchmark. PRESENTER: Is there a bit of a danger for multi-asset managers? I mean you've described a world where you've got very strong views on where the markets are going, both strategically and tactically, and how you balance out that risk. But if you then look at an underlying active manager who's got a very different view to you, he or she is a fabulous manager long term, doesn't it mean it's very hard for you to put them in that portfolio if you think value's going to go ahead and they're a growth person? ANDY BROWN: Yes it does. It can mean you have to switch managers within your, so even though your strategic asset allocation position might not change 20% in an equity market, you might have to move from a large cap value driven manager through to a small cap growth style manager, and anything in between. And also be prepared to mix them. It can be important to consider some of the things that have happened in the past. If I think about going back to the technology, media and telecommunications bubble in the late 20th century, some over 90% of the mutual funds available to access the US stock market were growth funds. Trying to find a value manager, which would have been the right thing to do at that time, was virtually impossible. Because most funds, and therefore most passive funds, the wall of money had pushed prices up, and the value stocks had fallen out the index. They just weren't there. If you move that forward to today where we might be a similar situation looking at some of the valuation charts, one would have to say that there are more value funds as a percentage of the market available to you. And you're able to pick managers who are sticking to the style, and they're quite happy to say I am this style and my style works in these scenarios. PRESENTER: But again is there a bit of a danger that if the market's giving you what the market wants short term that it becomes a sort of echo chamber? It's very hard to find those alternative diversified assets because nobody wants them, nobody's looking for them. ANDY BROWN: It can be, and that's where you go back to your starting point of what is it the investor actually wants? If the investor's asking to achieve a 4% income stream, for example, and the market's delivering 8% capital return and very little income, and you're swapping that over, that can be done at the product level, but the investment level you have to stick to what you're good at. And understand that over the long term what you see in growth at the moment, in the high growth low income, in a couple of years' time you can have exactly the opposite situation. For the client the outcome is exactly the same. For you as the asset manager achieving the average outcome through that is the most important thing you can give to the investor. PRESENTER: Could you talk us through how a multi-asset manager typically would decide that there is a mandate that they want a third party to fulfil, how do you go about that thought process? ANDY BROWN: I think the first point, the first thing you'd look at is your own analysis of the opportunity set that's in that marketplace. If it's a broad opportunity set, i.e. you think that a particularly country is at the bottom of its economic cycle and is about to start to come out, one would normally have said well that's when you start to invest in certain types of companies. You might sit and think OK so who has experience in large, mid, small caps? And then narrow your search that way. Or one could sit and think about a more sector driven approach where you're thinking OK which sectors tend to drag out of an economic downtown first, and therefore look for those managers. After that you're looking for evidence that the manager has been able to achieve that in the past. And you're also looking for I guess the flexibility the manager is allowed to have, or how much flexibility you want to give that manager in a mandate to I guess move sideways at certain times in those portfolios. Because that could be the times when the market's going forward at a huge rate and then give something back. You want to be able to protect the gains that you have. As you go through that upside down pyramid, and you're starting to filter managers out, you're then getting down to the real nitty gritty, how does the fund manager pick his stocks, pick his bets, and what is his process? What pricing are they able to achieve, and what kind of performance are you expecting, do you expect to get from that? And those performance targets can be quite important. Saying to a manager I think you go into this equity market, therefore I'm going to use that market, that stock market as your benchmark can sometimes be the wrong thing to do. PRESENTER: I was going to say, I mean if you invest in a third party manager, you can either buy their fund or give them a specific mandate to run on your behalf. What are the pros and the cons of each of those approaches? ANDY BROWN: Well there could be tax benefits to owning a fund over a mandate, certainly in some markets where there is less access to the market, and you have a smaller allocation to that. Then one can look for a fund which can achieve the broader diversification you need. The larger the amount of money that you're prepared to invest, the more likely it is that a mandate may benefit you. And actually the structure, the legal structure of the, or the framework of the mandate can provide you with the tax benefits. So it really comes down to I think size of the investment, what are you trying to achieve with that investment? A lot of large multi-asset managers may perhaps investigate markets by what I call learning by doing. They'll put a small amount into a fund, sit and watch it for a few years, and think OK that is behaving the way I would expect it to behave, I'll now start to think about increasing my investment. And that might mean moving into a mandate at that point. PRESENTER: Is it a bit, I mean when a fund manager's got their own fund they know the performance target they feel comfortable with, they have some control over the amount of assets they run, isn't it a bit dangerous as a third party to say to them we've got an idea of how you could run a mandate this much, slightly different from what you've been doing in your fund, be lucky? Does that always work well? ANDY BROWN: I think if I went back a few years the star fund manager culture that we had in the industry would not have lent itself well to turning round to AN Other famous fund manager and saying we think you could do better if you did it this way. I think fund groups, asset managers as a whole are much more prepared to listen to what the client wants. I think it's a lesson we can learn and pass down to the adviser community as well. Going along to a fund manager and saying I think you're quite good at this market, I need this particular shape of fund. And then working collegiately with them to build that shape, and come up with an interesting approach to getting the return you expect to get, is one that I've found most fund managers are more than happy to take part in. The intellectual challenge of that can be quite interesting for some fund managers. PRESENTER: What about capacity? I mean this because I guess you at the Pru are very big players. So does that push you towards certain styles that can run a lot of money, because otherwise why would you take somebody on for a very small mandate? ANDY BROWN: That's very true, and we have our own internal investment management capability as well through a couple of the fund groups that are owned by the larger group. So for us it's about attempting to find the right manager with the right style for the right time. If we can achieve that internally we're happy to do that. And if we need to go outside of the group to do that, we're happy to do that too. Generally speaking when you move to the less correlated assets that's when the opportunity exists for third party fund managers to really demonstrate their value, particularly in things like private equity space or the hedge fund space, where there is, the amount of resource that's required to be put into an algorithmic trading style for a particular type of hedge fund is one that you just really wouldn't want to have internally, because you would just be the only investor in that. Whereas going to another manager, they might be running other mandates for other clients around the world, and therefore they get the benefits of scale from that particular resource. PRESENTER: But to what extent when you're investing with a manager do you, can you guarantee that they won't take on so many assets from different sources that the fundamental mandate they're running for you, whether you've bought into a fund or they're running it for you bespoke, just blows up, they're running too much money? ANDY BROWN: Yes, it's a good question because it has happened in the past. You know lots of examples of that. I think when you're getting, when you're identifying a manager and you're working through whether you want to give them that, that can be quite a long-term process. Six to 12 months is not unusual once you've found a manager to try to better understand what it is that they're doing. There's also the legal structure of how you're going to instruct that mandate through. You need to ensure you always have ownership of those particular assets. And that operational due diligence part is really important, because it brings with it a relationship management where you would expect the third party manager or yourself to be able to engage on a regular basis to have those conversations about assets that are being gathered. There are examples again in the industry where a mandate has been given to a third party manager. It's been a successful mandate for the client, and the third party manager has launched their own funds. And generally speaking the manager and the client would get together and agree whether that was the right thing, because ultimately the mandate could switch to units in the fund. If you go back to the middle part of the first decade of this century property funds were in vogue, and we had a lot of insurance property funds, which switched assets into what was then authorised property unit trusts, because the tax rules allowed it. And so property went into the unit trust, and units of the unit trust went into the insurance fund. That's an example of the industry working together between client and fund manager to achieve probably a better outcome. PRESENTER: Well, you mentioned property, that does spring up the issue of liquidity. I mean it's certainly a big issue at the moment, what happens when you put less than liquid assets inside a daily traded fund wrapper? Are you, particularly when you get to the illiquids, do you tend to be more of a fan of closed end funds or can you, does it still make sense to buy open-ended funds? ANDY BROWN: It can still make sense to buy open-ended funds. It depends really what you're looking for. So certainly in some of the daily traded funds, NURS and UCITS funds, one would tend to go more for listed assets. Now whether that was in an investment trust structure or an overseas offshore arrangement, it really comes down to the impact of, it could be the political environment, the jurisdiction of that asset. It could be the tax structure of that asset that's probably more important. Equally on the mandate side of the fence, because you're the only investor you kind of know when you need to raise money. You know if you needed to redeem a certain portion of it because there was, a large outflow was expected because an individual had retired or something like that. And at times one has to think about not just property as an illiquid asset, but all of your assets in I guess a tiered structure of illiquidity. At the very top you have your developed stock and bond markets, and one should understand exactly how long it could take you to get out of a market. I think most insurance companies because they're heavily regulated will have already worked through how much you can redeem in one day, in one week and one month, six months and so on. And the asset management structure have adopted that process as well. But equally when you get to the bottom you can reach a point where property is not the only illiquid asset. Infrastructure is relatively illiquid, private equity is relatively illiquid, particularly if you're using a mandated form, or particularly if you're using a closed-ended fund. And one has to understand the impact of that on your overall cashflow into your fund, the find that you're recommending, or giving to IFAs to recommend to the client, and the income streams that are coming in from the other assets. And it can be quite a balancing act. It's nice to have lots of inflows and very little outflows, but if I think about the old insurance company world there are a lot of with profit products now which are what I would call over the top of the hill where there's more maturing policies and contributing policies. And they tend to have less illiquid assets and more liquid assets, albeit that they're probably more open to the vagaries of market movements. PRESENTER: So just so I understood right, if you've got a multi-asset fund that is, if I say in accumulation mode, it's bringing more people in than are taking money out, it's OK if you've got some illiquid assets in there because you might think well I'll sell, I've got plenty of FTSE exposure I could sell if people want to redeem. ANDY BROWN: Yes. PRESENTER: I'm OK with this money and infrastructure over here, and it's still throwing off income in the meantime. You've balanced these out. ANDY BROWN: That's right, it's a balance between the availability of that illiquidity premium, the streams of income that are being thrown off, which are generally higher than the bond market. And that can have great value in providing a cushion for our multi-asset fund in any downturn, and also the likelihood that you might need to sell assets to redeem units for your underlying investments. PRESENTER: One thing that was quite striking about active managers is the percentage of bets they get right compared to those they get wrong. Definitely they get more right than wrong, but it's not by a huge amount. When you look back at fund selection, your equivalent of security selection if you like, what percentage do you get right and what percentage do you get wrong? What's the ratio? ANDY BROWN: I'd love to say 51% right and 49% wrong. I think it's, at a fund selection level it can look substantially different. Because if you think if you have, let's use for argument's sake say you've got 10 assets you're investing into, and you're investing 20% in the first one, 15% in the second one and so on, then as long as you get the first two right that's going to drive a third of your overall portfolio returns, even though there are another eight. So it can be quite difficult. And there's also the timeframe that's involved. Sometimes I think the confirmation bias of that type of evidence leaves a lot of questions unanswered, because the timeframe is one year, three years or five years. Then it's about the market. Most of that evidence tends to look at the US market, S&P 500 in particular. You only have to go over the border in the US and look at the Canadian market and find exactly the opposite from that – what's the impact of UK market, European market, Japanese market? So I think it's interesting to do that analysis, but generally speaking I would find that thinking in those terms when you're picking funds is probably wrong, because you need to get your bigger bets. If your bigger bets are right, then you drive more of your performance. PRESENTER: But the reason I ask is because if I were an adviser, and I thought yeah I want to buy somebody who's good at asset allocation, and they add value through the fund selection, claim they can, what are the stats you need to look at to see whether the assertions by the produce provider are right? What's publicly available, what should you be able to demand and be given? ANDY BROWN: I think you can look at two different statistics. One is the contribution from your strategic asset allocation, and one is the contribution from stock selection, fund selection. And using tools like Morningstar, Financial Express, you should be able to identify how much return you're getting over the periods you want to define is coming through. One would expect that fund selection should add more in shorter periods, one, two, three, four, five years, and strategic asset allocation should add more over longer periods, five, six, seven, eight, nine years. There'll be a point in the middle, a kind of fulcrum point, where it will look pretty much as if you're getting an equal weight from both. It's not really the argument. The argument here is that time works. Strategic asset allocation as we mentioned before, being in the right assets at the right time for the right amount of time would tend to suggest that you get more over longer periods. PRESENTER: And are there certain sectors that you don't invest in, because essentially they compete with you? I mean something like global equities, if you as a product provider are thinking about your allocation, how difficult is it to buy something like a global equities fund, even if it's got a fabulous track record? ANDY BROWN: Yes, that can come down to the size of your fund. So depending on the size of your multi-asset fund you might need to operate in a more broadly diversified or geographically diversified sector. As your fund gets bigger you should be able to par that down and become more geographically sensitive to the areas that you think. There are some parts of the market which is quite interesting. I think about the demand paper and the charging cap for defined contribution schemes, and also the change to those default strategies. It has been quite difficult to achieve I guess a broader level of diversification you would have in an equivalent retail fund, because of the charge cap. One would say you probably couldn't access global bonds to the extent you would, because it's just too expensive. You might not be able to access property or illiquid assets. So therefore your overall diversification will be less. So it can really matter to the regulation or rules that surround the type of wrapper you have. I can matter the amount of money you have inside the portfolio to invest as well. And it can also matter the domicility of the investor. If all your investments are UK one would expect to have US centric assets just to prevent the currency risk, which has worked in your favour I guess over the past year. PRESENTER: We've talked a lot about selection investments, but what about the ongoing monitoring? When you've purchased a fund, how long are you looking to hold it for? ANDY BROWN: A great question. One would expect if you buy a fund you're going to hold it for the long term, because you hope that the manager's going to be able to continue to produce the… PRESENTER: The goods. ANDY BROWN: Primarily for performance reasons. The thing that you want from the manager, the thing that everybody wants from the manager, the first thing you would look at, what does this individual's performance look like? And as long as the manager continues to provide that performance on an absolute basis, or relative depending on what your original benchmark is, then that's point one. If they're able to do that for a number of years, you still at times may need to think about moving out, even though the performance track record has been fantastic, because you've reached a certain point in the economic cycle where you might thing that. So for example we're probably late economic cycle, late expansion in parts of the economic cycle at this point in time. You'd tend to be moving more towards cyclical stocks, and therefore you'd be looking for a manager who's got experience of making that move. You could have been with a value or a growth manager who's performed very well, but you still have to say thank you very much but I'll see you next time, as you move into different parts of the cycle. So the timeframe you want to be with a manager can be a matter of where you are in the economic cycle. It can also matter in terms of your blend. As your fund gets bigger you might be able to adopt a core and satellite approach, as opposed to a very large fund universe. So I think about some of the larger UK equity funds that were available a few years ago. One springs to mind which covered small, mid and large cap. It was a fantastic investment for us through our collectors, and as the fund's got bigger we made the move to break that into small, mid and large cap, and look for separate managers. Even though the manager that we had had done a good job for us, but to reduce the risk of one asset and moving that portfolio, we decided to move it into three separate pots. PRESENTER: And given how global the world is these days, are you spending more and more time looking at offshore funds, fund managers in different jurisdictions? To what extent do you still tend to start with the onshore UK fund sectors when you're looking for managers? ANDY BROWN: I think that is changing. I think that traditionally UK investors have tended to stick to funds domiciled in the UK. I think that's changing, certainly for us. We use managers domiciled in Singapore, in Hong Kong, in Chicago, in South Africa and all over the world. And at times that can be the right thing to do, because you're attempting to remove maybe geopolitical risk. You might be attempting to remove economic risk. You might be attempting to reduce your interest rate sensitivity when the developed world is worried about interest rate rises, and the emerging world is still in an area of interest rate cuts. So I think the range of funds that are available in the UK and domiciled in the UK is far greater. I can buy an emerging market debt fund in the UK for example now. Five years ago that was quite hard to do. But equally there may well be a manager sitting in Malaysia or India who's really good at doing that. The structure is one that depending on the legal structure of your fund. Is it an insurance fund or is it a collective? You might be allowed to buy it in one structure but not allowed to own in the other. PRESENTER: We're almost out of time, but one question that always comes up is fees. How much can it be worth paying for good active managers? ANDY BROWN: I have that conversation with active managers all the time. PRESENTER: I know they're all good. ANDY BROWN: And they all say that they're great. And some are really good, and it's worthwhile paying. I think from my perspective what I'm trying to achieve is efficient implementation of the design that we've come up with. If that means using an active and a passive manager together to achieve a good cost outcome for the investor, I'm happy to do that. I think active managers are well aware of that now. We've seen some recent moves by some of the larger asset managers on the face of this planet who have said well actually we can achieve an active style, albeit that we're using an algorithmic driven process to get there. Still some human involvement, but they're going to be able to do it for substantially less amount of money. I think that's quite an important move. How much would I be prepared to pay for an active manager? If it was a small asset class, if it was an international equity market or bond market, I might be prepared to pay more for that. Generally fees will get larger the narrower and rarer the market has to be; however I can't walk away from the fact that I'm telling investors we have a globally diversified fund, and therefore that needs to be taken into consideration. But overall the mix should deliver a reasonable outcome where I guess the investor's reasonable expectations can be met. PRESENTER: Final question, because we're pretty much out of time Andy. If you are, could leave people with just a couple of thoughts on why selecting managers is important with a multi-asset fund, what would you say? ANDY BROWN: I think it's important to be able to trust the individual that's making the stock selection decisions for you at the bottom. To understand the benefits that they've been able to pull through from markets into your portfolio is hugely important. Ultimately markets do all the heavy lifting. If you get the right call right then markets will give you a good return. There will always be periods in there where the markets will turn against you. A good manager will help to identify that before it happens, and put in place the right strategies to try to retain as much of the value that they've delivered to you in the period you've been invested with them, and allow you to take benefit of the effects of compounding interest. PRESENTER: We have to leave it there. Andy Brown, thank you. ANDY BROWN: Thank you.