form follows function

The design axiom captures the purpose of multi-asset investing

by Steve Snyder, Managing Director, Head of Multi-Asset Program, Commonfund
Interest in multi-asset investing is growing and the inflows confirm it: Institutional assets committed to multi-asset investing are reported to have increased to $773 billion at year-end 2013, up from $442 billion at year-end 2010, while the second quarter of 2014 represented the 11th consecutive quarter of fund flows into the strategy. The trend isn’t confined to the U.S., either, as industry data indicate that in Europe some €62.5 billion was committed to multi-asset funds in the first six months of 2014.¹

What is multi-asset investing? Definitions vary somewhat, but at its core it is about an efficient, resource-effective approach to maintaining a well-diversified portfolio. Multi-asset investing ranges from equity-specific or fixed income-specific funds to a single, commingled vehicle combining traditional domestic and international equities, emerging market equities, domestic and global fixed income, short-term securities/cash, and a range of alternative investment strategies. Forms of multi-asset investing can be found across a sliding scale—from a stand-alone strategy that is one allocation within an overall portfolio to a fully outsourced chief investment officer (OCIO) program at the other extreme.

The current surge of interest is actually a case of back to the future. The concept dates to the 1960s and ’70s, when it was also referred to as balanced investing, although at that time strategies were typically confined to U.S. equities and fixed income in the traditional 60/40 split. Providers were primarily large banks and traditional asset managers. Interest waned in the ’80s, as boutique investment firms emerged along with consultants serving in the role of asset allocator. Multi-asset investing began to return to prominence in the mid-2000s and has been gaining momentum since, a trend that can be attributed to many factors, including enduring recognition of the seminal study by Brinson, Hood and Beebower concluding that more than 90 percent of the variation in quarterly return could be explained by asset allocation decisions.

Although there are as many versions of a well-diversified portfolio as there are institutional investors, the desirability of a well-diversified portfolio is a near-universally accepted axiom. Yet, it’s easier said than done. Constructing and maintaining that well-diversified portfolio is a considerable challenge—and, thus, the fundamental rationale for multi-asset investing. For resource-constrained institutions, implementation is easier, the management of fund flows in and out is simplified, and important considerations—such as risk management, reporting and rebalancing—are usually integrated into the program.

Increased portfolio complexity drives adoption
A closely related factor driving multi-asset investing—as well as the related trend toward outsourcing—has been the increasing complexity of portfolios. This is accompanied by the realization—particularly on the heels of the financial crisis—that many investment committees don’t have the time to perform effective, timely oversight of portfolios. Typically, committees meet four times a year, and when they get together governance and policy issues often top the agenda (as they should). In all but a handful of instances, constrained staff size—and, in some instances, staff turnover—makes it difficult to adequately support investment committees with internal resources.

¹ Sources: Pension & Investments, eVestments and Thomson Reuters.
Risk management, reporting and rebalancing are important benefits of multi-asset investing. There are varying levels of risk management, but three, in particular, have come into their own in the past few years:

- Failure to meet institutional objectives;
- Operational risk, including due diligence and oversight of managers; and
- Portfolio liquidity/illiquidity.

Not meeting institutional objectives is foremost on the minds of trustees, who recognize that endowment performance is critical to mission. Many investment committees have a long-term objective of earning a rate of return that meets or exceeds spending plus inflation and management expenses. For most nonprofits, that’s annual spending of around 5 percent or, somewhat more conservatively, 4½ percent. With inflation pegged in the range of 2 to 3 percent, the resulting goal of 7½ to 8 percent to maintain purchasing power is not an easy hurdle.

The drive to meet institutional objectives
The traditional combination of asset classes — 60/40, 70/30 or 75/25 — may not get the job done. Thus, institutions have had to think about two things. First, lowering their spending rate or, at the least, smoothing spending through time; second, seeking to affect returns through the asset allocation mix, for example, constructing their portfolios with an equity bias and pursuing capital appreciation by including private capital or private equity real estate. Investors have also sought to build in downside protection, which has led to introducing selected hedge fund strategies into their portfolios. And then, certainly, inflation hedging has been a much discussed risk over the past couple of years, and we’ve seen greater interest in inflation hedging strategies (so-called real assets) being incorporated into portfolios.

Risk number two entails operational factors and due diligence. Even institutions with the most sophisticated investment committees face time constraints. What’s attractive about the providers of multi-asset vehicles is that they typically tend to be deeply resourced investment firms that are building portfolios from the ground up, including consulting on asset allocation, finding best-of-breed managers and performing portfolio analysis, often including risk aggregation.

The third area is liquidity. One advantage of multi-asset funds is retaining managers, particularly in the alternative strategies space, that institutions may not be able to access on their own. While that may make portfolios less liquid, some multi-asset funds have responded by providing accelerated liquidity. The multi-asset investor, for example, would gain access to hedge fund strategies, but not be subject to the same lockup terms as a direct investor in the hedge fund.

Higher importance given to reporting
Reporting is another major consideration. After the financial crisis, the industry has seen a much greater demand for transparency, elevating the importance of reporting for all investment managers, particularly multi-asset providers owing to the complexity of those portfolios, i.e.,
multiple strategies and multiple managers in one blended portfolio. Investors today want to know what they own and why. Thus, the development of a point of view becomes critical and, arguably, even more important is articulation of that point of view, allowing the investor to understand exactly why the portfolio is positioned the way it is.

Another service is the rebalancing that usually takes place on a regular basis for multi-asset portfolios. Thoughtful multi-asset portfolios are constructed with a long-term point of view (forming the “equilibrium portfolio” or “policy portfolio”). As there are real-time events demanding attention, the underlying managers may reposition portfolios daily, when needed.

Generally, however, refinements in the target allocation based on shorter-term opportunities and risks in the capital markets will take place on a monthly basis.

Benchmarking, a potential hurdle when multiple asset classes are involved, is generally addressed at two levels. Current performance is gauged by measuring the total portfolio (or broad asset classes for multi-asset equity and fixed income funds) or by creating weighted composite indices to serve as reference benchmarks to understand what is driving performance. Over the longer term, performance is often weighed against policy goals, such as the institution’s annual effective spending rate plus inflation and costs. (Commonfund offers a third benchmark of performance analysis compared with a set of peer institutions.)
Who are multi-asset programs for? A major source of demand has been smaller and mid-sized institutions because of issues such as resource constraints and manager access, as discussed previously. That said, there has been a great deal of interest from larger institutions as well, owing to ease of entry, a lighter administrative burden, a single custodian and year-end reports that meet audit requirements. Institutions of all sizes also like the ability to be nimble—to respond quickly when needed, without having to wait for buy-in and approval from investment committees at quarter-end.

**Multi-asset investing in a hybrid model**

Within the investing world there seem to be almost as many approaches as there are institutions. In many ways this makes sense as issues and needs are unique. For example, larger nonprofit institutions that work with consultants often use an implemented consulting model, in which varying degrees of fiduciary responsibility are delegated. In these instances, the consultant may make recommendations, based on an open architecture platform, concerning asset allocation, portfolio construction, and manager selection and monitoring. Much depends on whether the institution wants to outsource administrative functions. Those that really want a diversified portfolio but still want to maintain some control in a shared discretion environment might gravitate toward the multi-asset program. The same challenge exists as was discussed earlier in terms of the timeliness of changes to the portfolio, even within a consulting model. So, what we’ve seen in some cases is consultants advocating that a portion of the portfolio—say, about 15 percent—be dedicated to what is called “asset allocators,” but which is very much the same as multi-asset investing. This portion of the portfolio would be actively managed to reflect the current market environment, while the remaining 85 percent would be managed, essentially, as the policy portfolio.

**Conclusion**

Rooted in the natural world, the “form follows function” philosophy has found its way into architecture, product design, software engineering and other fields. Multi-asset investing is no different. It is an approach to investing that takes its form as a result of the function it performs for institutional investors including:

» meeting the challenge of building and managing well-diversified portfolios; managing the increasing complexity of today’s portfolios;

» the need for robust risk management and transparent reporting; access to managers and strategies; and

» the speed and agility to respond to rapidly changing capital market environments.

Multi-asset investing takes no single form; once again, it responds to the function it performs—from asset class- or strategy-specific allocations with client retained or shared discretion to comprehensive solutions.  

Multi-asset investing responds to the function it performs.
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