Endowment Style Investing Made Accessible

An exciting development that continues to evolve

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The current period of low rates, unprecedented low volatility, lack of dispersion at all levels, and middling non-equity portfolio returns continues to draw investors towards considering multi-asset investment managers. Multi-asset investing generates a good deal of press, ranging from the definition to the proper implementation. For the past several years asset managers have commercially built out capability and rolled out products to meet the interest level. The offerings, historically available to large institutional investors, are now available to a wider swathe of investors in co-mingled and customized vehicles. It is this access by most levels of investors, including private investors, to the "endowment style" of investing employed by the most sophisticated investors that is getting a great deal of attention.

Multi-asset investing can trace its roots back to the balanced funds of the 1920s (some of which still exist) which first incorporated standard, liquid equities and bonds in a single fund. This mix of domestic equities and investment grade bonds in 60/40 weights has certainly stood the test of time and is still a benchmark.

Endowment style investing, of the type that Yale's David Swensen developed and popularized, clearly paved the way for a broader adoption of multi-asset investing. As the breadth of asset and strategy choices have grown the model continues to evolve. This includes the introduction and in some cases reliance for returns upon less liquid strategies like private equity. The inclusion of these "illiquids" as compared with a balanced fund of public equities and liquid bonds has necessarily changed the liquidity profile of multi-asset investing from its beginnings. It is, however, the ability to access these hard to access and in some cases unique exposures, which is attractive.

Bringing endowment style investing to a broader investor base

The desire and attempt to provide access to an institutional pool of assets and strategies is not a new one. Smaller institutional and high net-worth investors have long pined for the enviable returns generated by a Yale-like model over multiple investment cycles. Having survived some failed attempts, a select few of the latest generation of multi-asset managers seem up to the task of getting the exposure into more portfolios. The first consideration should be one of suitability for the investor.

Portfolio fit and investment motivation

An obvious but critical issue is the role of a multi-asset fund in a broader portfolio. For large institutions that utilize a multi-asset investment style the exposures under that banner are the entire portfolio, although they are generally housed in multiple sub-funds/investment vehicles. For those, generally smaller, investors seeking to add this exposure as one component of a larger portfolio the question is one of role and purpose in the broader portfolio. Behind this role definition is the closely related issue of the investor's motivation. Given the diversification/all-weather and longer-term nature of the portfolios, a multi-asset fund can serve as a core holding in many portfolios. While selection and monitoring of the manager are important the goal might be to use this allocation as a less-volatile anchor, or bond-like substitute to other exposures.

Fees

Multiple layers of fees that potentially misalign the portfolio manager and the investor are increasingly in focus. Investors are rightfully only willing to bear higher fees for true alpha, not beta disguised as alpha. The multi-asset community has responded by themselves carefully considering fee levels in all parts of the portfolio. There are a select cadre of multi-asset managers that have the resourcing and scale to create bespoke exposures run by external managers. One of the key negotiated elements here is the fee level. This thoughtful alignment and structure of fee load which accrues to the investor is another benefit of this approach.

Open versus closed or partially closed architecture

In the last few years as multi-asset has become yet another industry buzz-word, many industry participants have formed multi-asset groups and rolled out products designed to meet demand. In many cases the first foray on the product side was merely corralling the firm's existing internal product suite into some sort of wrapper/vehicle to be marketed as multi-asset. This closed architecture has obvious drawbacks as the firm is only using its own products and portfolio managers.

Open architecture, even if an internal product is ultimately selected, should provide a wider palette from which to construct a multi-asset portfolio of the highest quality. The drawback can be higher fees, liquidity issues if a change is desired, and ceding management control. It does seem to make sense though for this new generation of multi-managers to adopt this approach, which most closely mimics the successful endowment models.

Unconstrained investing in terms of asset and product selection would seem to be the most favored starting point. Of course, this comes with the caveat, as below, that filtering through all the choices requires a great deal of expert resources. The independence of the team's decision tree is paramount and puts the performance onus squarely on their shoulders.

Portfolio construction in open architecture

The manager needs to go beyond simply mixing asset classes in some rationalized percentages. Rather a careful examination of the drivers of risk and return for each individual asset class and strategy must be undertaken. This is really a look at the various risk premia with the first decision point being whether it is desirable at all for inclusion in the current and forecasted environment. It should also involve a look at the characteristics of the risk premia and a consideration of whether to seek the exposure through an active or passive approach. On the passive side, there can be considerable savings to the portfolio versus hiring an active manager to accomplish the same objective.

Beyond a fully developed multi-asset approach, the capability to implement is crucial to differentiation and ultimately performance. Assembling the right combination of assets, strategies and managers to execute the strategies, in a risk-conscious and cost-efficient manner has always been the challenge. The goal is to meet the established risk/reward objectives while managing the book on a forward-looking basis to eliminate/mitigate unwanted risk while seeking wanted risks and market opportunities. Investors clearly want an outcome focused approach to meet their investment needs. This should be coupled with a thoughtful risk management framework (lacking in many offerings).

Strategic and tactical asset allocation

The manager adds value through asset allocation and this should be measurable over a longer-term track record. The long-term blend of assets falls under the Strategic Asset Allocation header. These shorter-term adjustments in anticipation or response to market conditions is termed tactical asset allocation and may be clearly seen in the monthly performance. TAA has had mixed results, but fits with the basic premise of assets behaving differently at different points in time that is a tenet of multi-asset investing. Periods of low dispersion amongst asset classes, strategies and managers, are challenging and only marginally overcome by the selection process.

Actively managed strategies can provide real value and be a key source of outperformance (alpha). The difficulty with active manager selection, as always, is figuring out which managers have real, repeatable, and difficult to replicate investment skills, processes and the infrastructure required. This process of vetting out managers, in turn, requires dedicated resources with the proper training and background to be able to do so effectively in the given asset class/strategy.

Passive strategies can and should also be used where appropriate to gain wanted exposures (beta)

Fig.1 Diversified Growth Fund AUM Growth *Source: CAMRADATA*

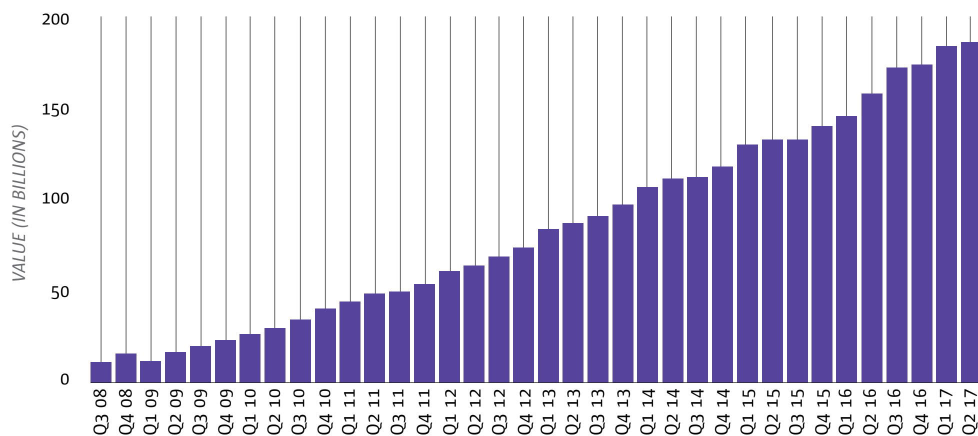
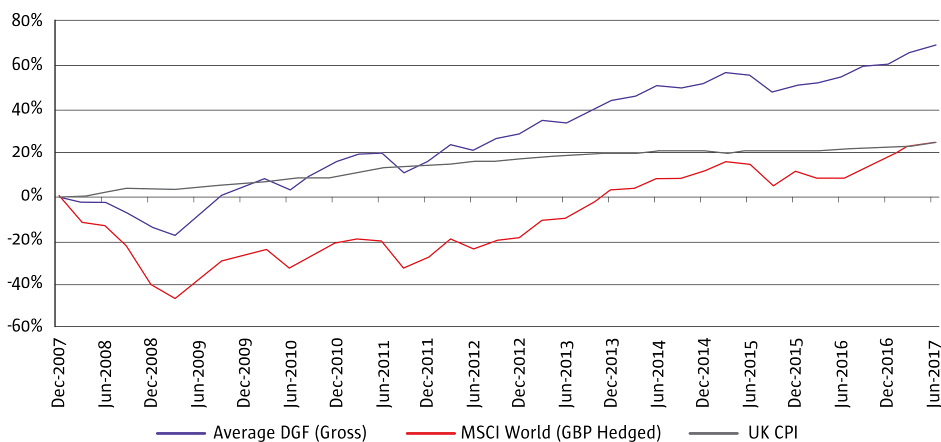


Fig.2 DGF Performance Since 2008 *Source: Willis Towers Watson*



in a cost-efficient manner. The selection of passive products and managers however also requires the resources to properly evaluate all the components and select the best product for the desired risk sought. Given the huge shift to passive, there are bound to be some calamitous issues with certain products or providers, especially in risk-off markets.

Customization has long been a hallmark of respected endowment investing. This customization of exposures by external managers is a benefit reaped by those funds with enough scale and expertise. For example, instead of investing in a co-mingled green energy fund, some managers are able to source direct or co-investments tailored to their views or mandates, resulting in a targeted exposure with greater transparency and often more attractive terms, including economics. The creation of these bespoke exposures, designed to the multi-asset manager's specifications and often unique to them, is a measurable evaluation tool. It provides a means for the smaller investors in particular, to participate in markets/products formerly blocked by barriers to entry, including minimums.

Perils of the past

The most glaring mistake of the past in trying to provide endowment investing to a broader group of investors has been a mis-matching of the underlying liquidity of the assets and external manager vehicles with the fund liquidity offered to investors. The wide-spread distribution of the funds by investment firms/banks with added layers of fees exacerbated the situation once returns floundered. As discussed elsewhere, the 1.0 versions of multi-asset erred on the side of being a simplistic re-packaging or combination of existing products at many institutions. While this was done to meet investor demand, it is a less than ideal approach and did result in some amorphous blobs in the category which failed to perform and in some cases left investors with a negative bias.

Traits of multi-asset managers

While many of the traits that investors should seek are common to selecting most asset managers, the evolution of the approach to version 2.0+ suggests focusing on key ones:

- Avoiding an "everything but the kitchen sink" approach is critical. The manager should have a clear and transparent strategy which results in a thoughtful combination of asset types and strategies. It is best if the results are not overly reliant for return upon tactical asset allocation and if the portfolio's diversification can withstand changing/stressed markets. If followed the fund should be easily assessed including for attribution at all decision levels.
- Since many multi-asset efforts are fairly new, sourcing one with a pedigreed team with a lengthy collaboration can quickly shrink the potential pool. While the parent corporation may have changed, finding a longer track record with an intact team can help reduce any future surprises. It is particularly instructional to find a team that has managed a portfolio through multiple cycles including the 2008 crisis.
- Funds should not be overly reliant upon one asset class or manager for returns over a market cycle. If the attribution analysis shows all the returns are coming from a single asset class, or worse one manager, this is to be avoided. The principal of assets behaving differently across a cycle needs to be given a chance, so a diversified approach is favored. This does not mean that there cannot be zero investment in asset classes deemed to be unattractive for some future time period.
- A key reason to seek out multi-managers is to participate in a set of returns otherwise inaccessible. So finding a manager with a large percentage of bespoke and even unique positions can be a crucial selection criteria. Obviously, the exposures need to be thoughtful both structurally and from a forward-looking investment perspective.
- The multi-asset manager's size is also a consideration, as the largest managers cannot pivot effectively and may have to exclude all but the largest capacity opportunities.
- Offering a multi-asset fund with daily liquidity is very restrictive and removes a large swathe of return drivers that have been the leaders in performance attribution.
- One of the biggest challenges for multi-asset managers is having the resources to effectively manage a portfolio using this diversifying approach. While the fund can be managed with a

relatively lean staff, those staff need to be supplied with a well-vetted palette of all types of managers (e.g. passive, active, deep-value, systematic, etc.). Putting together these building blocks for the portfolio team to use requires great knowledge and expertise in all asset classes and strategies. It is these deep and wide due diligence resources that can help the allocation team create a durable, well-balanced portfolio. Having such a team of analysts (both investment and operationally focused) is no small or inexpensive undertaking. Those firms that have figured out a methodology for sharing these resources with different business verticals seem best able to strike a balance between quality, cost and efficiency.

- Investing in a multi-asset fund is an outsourcing of the asset allocation process to a team that is being hired to add value in terms of access, vetting and making forward-looking changes to the mix. Dynamic asset allocation which can be shown to have provided value should be sought. Here, a team that develops a clearly defined set of themes which they believe will be those that result in the best risk/return profile should be selected. The translation of these themes into executable portfolio expressions is obviously critical. Having a view that technology-driven disruption of businesses will likely result in a range of opportunity is great, but the real art or science is sourcing out ways to put this theme into action.

The ability of a wider group of institutions and sophisticated investors to participate in high-quality endowment style investment exposures is an exciting development and one that continues to evolve. The current offerings need to be carefully considered using traditional, and more targeted multi-asset fund evaluation criteria. These medium to long-term horizon managers can occupy an anchor position in many types of portfolios and be protective given the level of diversification.

Increasingly, in the period of low returns, investors are seeking out exposures that were formerly only accessible by those with scale and sourcing. In the broad multi-asset category there are a selection of pedigreed managers that have a variety of offerings to suit an investor's specific goals. As with all manager selection processes, there are certainly some attributes which separate a few from the pack. **THFJ**