Multi-Manager Mindset

STANLIB Multi-Manager
Quarter 1, 2016

Focused Investing
STANLIB Multi-Manager

Additional diversification
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With all the economic challenges facing our clients and advisers, we realised that there is a need for independent thought leadership to provide investment guidance on the way forward.

We have chosen our articles based on feedback from you with the intention of challenging your existing thinking and to provide you with additional levels of understanding on relevant concepts.

For those not familiar with the STANLIB Multi-Manager business, we have seen significant growth over the last two years to the point where we are currently the custodian of more than R150 billion assets under stewardship. During 2015, we also became the largest unit trust multi-manager in the industry.

We believe the most significant contributor to this success has been our great performance track record since our inception in 1999. In excess of 70% of our unit trusts rank in the top 2 quartiles relative to our peers, we were pleased with our recent Raging Bull award for our STANLIB Multi-Manager Global Bond Fund.

The focus of this edition of Multi-Manager Mindset is diversification. There was very little to get excited about during the last 12 months from an investment perspective, in fact there were many historic lows. We believe a key principle to have guided investors through this volatile period was diversification.

In this edition, Joao Frasco, our CIO discusses the need for diversification of manager specific risks, which is the cornerstone of our Multi-Manager business. Kamini Moodley, Head of Manager Research, then unpacks what makes managers different and explains where they fit on the manager continuum. In our third article, Richo Venter, Head of Research and Development describes how to blend multi-asset managers and mandates, which is different to selecting a blend of specialist managers. Finally Kent Grobbelaar, our Global Portfolio Manager based in London, touches on the different layers of global diversification, which is not just about currency.

Please look out for this publication in the future and provide us with feedback on this new initiative. We welcome your ideas for our next issue.
Diversification comes in many different forms, and at many different levels in the investment process. Investors often forget this, thinking that a fund invested in various shares is well diversified. Thinking about diversification at the security level (e.g. shares) is sometimes simple, but fails to recognise that a single economy/market/currency/asset class has many idiosyncratic risks that are not diversified when you are invested in just one of them. I will explain idiosyncratic risks in detail later in this article.

Diversification has long been described as the one “free lunch” left when investing, as all other returns require the investor to accept some risk (in which ever form it may take). We like to think of diversification as less of a free lunch, and more of an unrewarded risk that investors should not be taking (idiosyncratic risk is by definition diversifiable, so why would anyone reward you for taking it).

It is sometimes easier to understand how you achieve diversification by considering investing in multiple asset classes e.g. equities, bonds, property and cash. It is also simple to understand that further diversification can be achieved if you invest in many different securities within each of these asset classes e.g. shares and bonds issued by many different companies. Understanding why it is necessary to diversify across different economies and currencies, is a little more difficult.

Understanding idiosyncratic risks

Let’s begin by understanding idiosyncratic risk, as this will provide a great foundation for understanding diversification fully. Let’s consider two “technology” companies (it doesn’t matter which two, and we will therefore not focus on comparing two specific companies). You may think that owning just one of the two companies will give you exposure to technology companies, but you would only be partially (and potentially very marginally) right. Both companies may have exposure to global trends in technology, but there is no guarantee of this.

The companies could operate in different countries (subject to different laws and regulations), have revenues from different geographies, industries and clients. They could provide completely different products and services (some of which may be well established product lines with little or no future prospects for growth, while others which may have very little current revenue prospectus but massive future opportunities). The companies are run by different people (management and staff), who all have different backgrounds and experiences, which will inform their business practices and strategies. The list of differences goes on and on.

Over the short term, macro events could force these companies’ shares to perform in a similar way, leading investors to focus too heavily on the lack of diversification provided, but this is one of the most misunderstood aspects of what diversification purports to offer (investment horizon is critical). Over the long-term, no two companies will share the same fate. Apple almost shut down in the mid to late nineties, and is now the largest market cap share in the world. Microsoft didn’t exist fifty years ago, and their software sits on most home and business personal computers today. Facebook and Google hardly existed a decade or two ago, and are some of the biggest technology companies in the world. Extending
the investment horizon to months and years will quickly highlight the benefits of diversification, not only between two companies/shares, but also between two asset classes/markets.

To summarise, every variable and decision will make two companies different, creating idiosyncratic risk. While combining two such companies will not remove the risk of the macro factors that will affect both companies (e.g. currency depreciation), it will diversify those idiosyncratic risks.

This is all of course very well understood by all investors (professionals, amateurs and the lay person alike), so everyone ensures that portfolios are well diversified across all of these variables, the most important of which are asset classes (including geographies / markets / currencies), and across securities within asset classes (for example, shares and bonds from different companies / issuers). To the extent that you want maximum diversification, we could all invest in the market portfolios (the portfolio of all investible assets, which is very different from just investing passively in a single index that comes with its own idiosyncratic risks).

Single manager funds introduce further idiosyncratic risks

We however, don’t choose to just invest on this basis. We look to active management to seek the possibility of outperforming by looking for market inefficiencies or mispricings. While this provides a great opportunity to achieve even higher returns (or returns more aligned with our goals/objectives or liabilities), it also comes with very specific or idiosyncratic risks. Every asset manager sees the world slightly differently, because every manager is slightly different (or very different, depending on which two specific managers are being compared).

So investors who have gone through some deal of trouble diversifying all the idiosyncratic risks of asset classes, by investing with asset managers who have gone through some deal of trouble diversifying their mandates, by investing across a number of securities, find themselves having introduced new idiosyncratic risks because of their chosen managers’ philosophies and processes (people, assumptions, models etc.). Multi-managers address this very risk by diversifying single manager idiosyncratic risks.

Now, you could have worked out that this “rabbit hole” has no end i.e. doesn’t a multi-manager introduce further idiosyncratic risk in the removal of single manager idiosyncratic risks, and the answer is “yes, they do”. Now it becomes a question of establishing how much risk is introduced versus how much is diversified. Not only at the level of the multi-manager, but at all levels above this as well. Most investors recognise the benefits of diversifying at the asset class level, and this is very well established in the investment literature.

Let’s however look at the difference in performance of managers all doing essentially the same thing. We will focus on South African managers managing balanced (multi-asset) mandates. I’m going to look at monthly returns for the ten years ending December 2015, and I’m going to use net returns for Collective Investment Schemes (Unit Trusts) in the ASISA South African High Equity category. The graph below is a risk/return scatterplot of 39 funds. Some people may look at the difference between the top performing fund and the bottom performing fund, and not think much of the difference of approximately 11%. Most investors actually just invest in the top performing fund thinking that it will magically be the top performing fund for the next 10 years (something that never happens).

The difference of 11% is however a rate per annum i.e. it is 11% for every of the 10 years. On a cumulative compounded basis, this difference is actually 307% i.e. 184% versus 491%. Put differently, if you had invested R1000 on 1 January 2006, you would have had R1840 in the worst performing fund, and R4910 in the best performing fund. While a multi-manager doesn’t promise that you will be in the best performing fund, it will ensure (unless it is completely incompetent) that you are not in the worse performing fund either. You will (not surprisingly) find that the multi-managed funds lie above the middle (or average) of the pack, bubbling further up as time passes and once great managers go on to underperform (which we see over and over again).

What are the alternatives?

You could, as an investor, do this yourself i.e. just invest in a couple of funds to diversify single manager risk, but you shouldn’t be doing this on other people’s behalf without doing the required due diligence work.
on all the single managers you choose to invest with. This is one of the primary functions performed by a multi-manager i.e. research the universe of available managers to understand their philosophies and processes with the objective of forming a view on which managers are likely to outperform over the medium to long term, and which managers to avoid. You can perform the exercise above across other asset classes and across other regions in the world, and you will find very similar results, which is why multi-management is growing so quickly around the world.

As markets get more complex, more asset managers enter the market to facilitate understanding and extract value for clients. They in turn bring their own complexity, which multi-managers and consultants enter the market to address. Asset managers make markets more efficient through price discovery (and information discovery), and multi-managers make the asset management industry more efficient by allocating capital to the best managers and taking it away from those that destroy value for clients.

In conclusion

The next time you think about investing and the diversification you’re achieving, remember to think more broadly about the idiosyncratic risks you’re introducing through your decisions, and the idiosyncratic risks that your managers or your investment strategy is not addressing, and remember that these risks are not being rewarded, so why are you taking them.
An uninformed investor’s predominant method of selecting managers is based on past performance, i.e. managers that have appeared in the top quartile historically, without always understanding the drivers of alpha for the underlying manager. Our research shows that the flaw with this type of selection is managers who appear in the top quartile in one period do not necessarily persist in this ranking in subsequent periods, meaning managers who are the top performing managers in one period could go on to become the worst performing managers in the following period.

The importance of understanding past performance is no guarantee of future performance is the premise on which our manager research function is based. A manager’s alpha profile is determined by a combination of factors, including:

- The portfolio manager
- The size of the investment team
- The investment experience of the team
- The organisation of the team
- The quality of team discussions, views and debates
- The investment philosophy, and
- The investment process

While we cannot predict how a manager will perform in future given the uncertainty in the market, we can prepare ourselves with a good understanding of the above dimensions, which then allows us to make great investment decisions based on our expectations.

Within manager research, we place very little weight solely on the actual historical performance of a manager; obviously it is not ignored in its entirety as it provides a litmus test for understanding what type of alpha the manager can deliver given their philosophy and process. For example, one would expect that a manager who purports to be style agnostic would deliver a smoother alpha profile over time than a manager who exploits a value style of investing, all else being equal (e.g. both managers are similarly benchmark cognisant or agnostic).

However, in many instances it is other qualitative factors that influence this alpha profile. Therefore it is increasingly important to understand the differing philosophies, styles and processes of managers when making a decision around the combination of these managers into one solution.

Over the coming months, we will provide some insight into a few of the aspects that make managers different and provide some clarity as to why it is important to understand where managers fit within the continuum that make up our asset management industry.

What makes managers different?

All managers are different but they all have one thing in common in that their primary objective is generating positive alpha over time (i.e. outperforming its benchmark and hence adding value rather than detracting value). Despite this common objective there are a number of aspects that make asset managers different, all of which have implications on their ability to generate alpha over time. We have highlighted just a few of the differentiators that we find important in developing an understanding of these managers:
Organisation of the manager (i.e. is the manager a large institutional type manager or a boutique owner-managed business?). The organisation of the business has implications for how decisions within the investment team are made.

Size of assets under management, may have consequences for the managers’ ability to extract some premiums that are available.

Value, growth, momentum, valuation, quality – where do managers focus within the market continuum or are more managers emerging as style agnostic given the limitations of alpha opportunities?

Incentivisation and alignment of interests of the investment team. How invested are managers in their own funds and does this impact investment decisions taken?

Fundamental bottom-up, top-down or a combination of both in stock analysis and how does this translate into portfolio positions (holdings and sizes, absolute and relative)

Organisation of the investment team - sector specialists or generalist analysts. Are there implications to this?

Multi-counsellor (each running distinct portfolios), multiple portfolio managers (all running the same fund), or single manager decision making.

I will elaborate on the first three dimensions detailed above in this article and will expand on the other dimensions in our next issue of the STANLIB Multi-Manager Mindset.

Organisational structure

The organisation of the manager (i.e. ownership structure) may have significant implications for the investment team in terms of the freedom the team can exercise when making investment decisions. Belonging to a larger holding company or life company may impede the ability of the investment team to express their best ideas for two reasons,

Firstly satisfying the expectations of external shareholders in terms of delivering shorter term performance while abiding by a long-term investment horizon does provide some challenges; and

Secondly despite having the depth of understanding to express high conviction views, affiliation with a life company may result in the expectation that a manager stay closer to the benchmark as we have seen in a few instances.

As a consequence of these ownership structures and external pressures; more recently we have seen a number of investment teams break away from their parent company to establish smaller, investment-focused owner-managed businesses – this would naturally lead one to assume that belonging to a larger business impedes the ability to make investment decisions in the best interests of clients, but is this really the case? What we’ve seen in the analysis of managers is that teams want to focus on making the best investment decisions for clients without “business interference”. It is obvious there are pros and cons to both approaches and this will need to be assessed in the broader context of the managers research.

Size of assets under management

Size of assets under management may limit the ability of the manager to extract certain alpha premiums. Smaller more nimble managers have the ability to extract the small cap premium where larger managers cannot due to size constraints. Depending on what the market favours over a time period, this may lead to a lost opportunity as a consequence of size. Understanding how the size of a manager limits or expands the opportunity set is important in understanding the type of alpha outcome the manager can deliver. If you look at the performance of a universe of equity managers over the period July 2012 to August 2015 the managers that have generated the most alpha over the period have been the boutique asset managers.
Manager styles

One of the most important differentiators for managers is in their manager style. Some managers exploit value type opportunities, while others play more within the momentum side of the market, some purport to be style agnostic enabling the fluidity of moving where the opportunities present themselves.

Understanding where managers fit within this continuum is paramount in manager allocation or portfolio construction to achieve a more stable alpha profile, with the combination of these managers, which is what the multi-manager offering aims to achieve as displayed by Figure 2.

Understanding the philosophy of the manager will allow you to understand how closely the managers will play to the benchmark, i.e. benchmark cognisant or not, and also what type of opportunities the manager will exploit given the style of investing. Figure 3 below reflects the active return against tracking error of a select few managers over the period December 2010 to November 2015 – this highlights how managers’ active return outcomes have evolved over time given the level of benchmark risk taken. We highlight some managers below, ABSA, Aylett, Coronation, Investec Value and Mergence Equity for their equity offering over this period.

MULTI-MANAGER VS SINGLE MANAGER ALPHA PROFILE
Let’s look at Investec Value and Mergence Equity to explain the difference in manager style and how this plays itself out in the portfolio construction. Investec Value for example has a contrarian, deep value benchmark agnostic style as you can see with the tracking error ranging from 10% – 20%. Understanding that this manager is a more deep value, contrarian type manager and what this would mean for diversification purposes when combined with other managers is important. This manager’s style of investing currently has resulted in a portfolio that comprises of resources and cash.

Mergence Equity on the other hand is more benchmark cognisant and style agnostic with a tracking error of around 4% relative to the SWIX, exploiting opportunities within the quality large cap counters. This style agnostic behaviour would allow the manager to move wherever opportunities lie within the market and hence promote a smoother alpha profile going forward. The manager has historically been more skewed to value counters in the past but has now moved to incorporating a more pragmatic value style. One would not be able to understand this evolution of philosophy by focusing on their performance alone.

Understanding these nuances is important when managers are being combined. One would need to ensure that they play to the different dimensions of the market rather than being significantly skewed to just one. Blending these managers together could result in very different outcomes if one does not form an appreciation for how managers’ philosophies translate into portfolio positions. Of equal importance is understanding if managers remain true to their philosophy over time despite the style underperforming.

Conclusion
Managers fall within a broad market continuum. Understanding the underlying philosophy and process of managers and how this translates into decision making is only one aspect; the differences in the manager style, organisation of the investment teams, AUM progression and size, risk management and incentivisation all play an important part in understanding how managers differ. These characteristics have implications on the drivers of alpha and the performance the manager can deliver over time.
STANLIB Multi-Manager

Largest Collective Investment Scheme multi-manager in South Africa
Multi-manager portfolios first came to light in the 1980s, but became more prominent as an investment model in the 1990s. A multi-manager does not invest directly in stocks, but appoints a number of portfolio managers - usually referred to as single managers - and spreads investments amongst these selected managers. Most investors, advisers and portfolio managers agree that investing in multiple asset classes including equity, cash, bonds, property etc. (generally called a balanced portfolio) provides a well-diversified portfolio for an investor. A multi-managed portfolio is based on the exact same principle – diversification, but amongst managers, to improve risk-adjusted returns for clients. Three levels of diversification are therefore achieved in a multi-managed portfolio: single manager diversification, asset class diversification and instrument diversification. Single manager portfolios only achieve asset class and instrument diversification.

One common mistake made by investors is selecting managers based on their past performance. Very few managers are able to consistently deliver great performance for various reasons (sometimes the seeds of future underperformance are actually sewn in great past performance). This means investors are at risk of choosing yesterday’s star managers rather than tomorrow’s. Optimal risk-adjusted returns are achieved through the selection of multiple managers with different investment philosophies and processes that are expected to outperform in the long run. By blending these managers at appropriate weights, improved risk-adjusted returns can be achieved.

Volatility and risk-adjusted returns

Volatility is calculated as the annualised standard deviation of the change in price (i.e. return) and relates to the uncertainty or risk of returns. If the price of a stock or portfolio changes by very different amounts (in percentage terms) over time, it generally has high volatility. If the price changes by similar amounts, it has low volatility.

A portfolio with high volatility therefore has more ups and downs and is more risky, while a portfolio with lower volatility provides a smoother return, resulting in a less risky investment i.e. in this particular sense, risk is proxied by the uncertainty of returns. It is however very important to measure this over appropriate periods of time and to consider whether the volatility is not capturing the “true” underlying risk in an investment e.g. writing deep out of the money call options may yield very low volatility of returns until the option expires in the money and bankrupts the investor. Cash is considered as a low volatility investment - each month you know with a high degree of certainty what your return from your cash investment will be, with very few (if any) default events. Regardless if stock markets crash, your cash return is still fairly predictable in most days, weeks, months and even years. Occasionally, you may have an event like the African Bank bailout, which may cause your “cash” investment to suffer massive losses, but these events are rare, especially relating to bank deposits. Shares have a much higher volatility. The stock market can be up 5% today and down 10% tomorrow (although this is fairly rare) and can be quite nerve wrecking for an investor who is not comfortable with swings in prices. As we all know,
it is very difficult to predict what the stock market will do next.

As an investor, a 10% expected return from a low volatility investment like cash is preferred to a 10% expected return from a much higher volatility investment like shares. A risk-adjusted return is a calculated measure that allows for a comparison between investments or portfolios with different volatility. It measures the amount of return per unit of risk taken. The Sharpe ratio is the best-known risk-adjusted return measure. You calculate an investment’s Sharpe ratio by taking the annualised return for the period under consideration (typically three years using monthly returns, but longer periods are generally favourable), subtracting the annualised risk-free rate over the same time period, and dividing the result by the volatility of the returns for the period.

Diversification explained

There is a well-known saying that “you should not put all your eggs in one basket”. This is why managers (or investors), will typically invest across many different companies’ shares and bonds, providing diversification across geographies, economies, sectors, clients of those companies, cyclical exposure of those companies, etc. The same applies to investing in a single manager fund - if all your money is invested with one single manager, you are reliant on the performance of this manager, which will be driven by the many idiosyncratic decisions taken by this manager (including their philosophy and process, their team and all the individuals, their models and the assumptions used, etc.). Spreading your money across multiple managers, diversifies this idiosyncratic risk, minimizing the possibility that poor performance will negatively affect your overall portfolio performance.

In cricket – the best international teams have a balanced mix between solid batsmen that score at a slower defensive pace but accumulate lots of runs and some hard hitters that can quickly score fifty runs towards the end of an innings. Think of South African greats like Jacques Kallis and Lance Klusener. Although very different in their batting approach, these individuals complement each other and the team’s performance. Diversification in investments is very similar, and occurs when you spread your investments across different securities, asset classes, and managers. Some managers will do well when others do poorly, reducing the overall volatility or risk of your portfolio.

While this principle is generally well understood by most investors, some fail to recognise the additional opportunity of selecting great stocks or managers, in addition to diversification. Passive investing achieves diversification while potentially leaving the opportunity to outperform on the table. Similarly, arbitrarily choosing a number of managers to blend achieves diversification, but leaves the opportunity of outperforming by choosing and blending great managers on the table. For advisers, the problem is actually more serious, as the basis for their choice must be well researched and cannot be done on an arbitrary basis like based purely on past performance or on the size of a manager’s assets under management (AUM).

Correlation measures the extent to which two assets move together. When two assets always move up and down together, their correlation is +1; when they always move in the opposite directions, their correlation is -1 (a hedge); and when they move independently, their correlation is zero (great for diversification). The closer the correlation is to 0, the more diversification benefits can be achieved. A correlation of -1 is never ideal as it just represents a perfect hedge i.e. removing risk completely. It is important to note, and is often very poorly understood even by professional investors, as long as correlation is not perfectly positive at +1, diversification occurs i.e. two correlated assets still offer diversification. A well-diversified portfolio reduces risk without giving up returns.

Balanced example

To illustrate the concept of improving risk-adjusted returns, five balanced single manager funds were selected. These managers were purely selected for illustration purposes and no recommendation is made about any of these managers. Although we picked five managers that illustrate our point quite well (by using managers with similar Sharpe ratios), the concept will apply regardless of the managers selected. A five year history was used to analyse the diversification benefit of blending these balanced portfolios. The illustration is presented in absolute terms and not relative to benchmark (active returns). The reason for this is that a balanced investor is probably more concerned about performance relative to an absolute measure like initial capital invested, cash or inflation. Note that different fee classes were used due to availability of information, which has an impact on performance. Again, we need to stress that the focus should not be placed on the actual performance of these managers but rather the illustration of the diversification benefits.

Had we combined these five funds in equal weights, the resulting portfolio would have had a return
equal to the average return of the five managers but the volatility would have been less than any of the single managers at 6.4%. As long as these five managers are not perfectly correlated, the combined portfolio will always provide diversification benefits which will translate into higher risk-adjusted returns (Sharpe ratios).

Table 1: Correlation matrix of nominal returns

<table>
<thead>
<tr>
<th>Portfolio name</th>
<th>Allan Gray Balanced A</th>
<th>Coronation Balanced Plus A</th>
<th>Discovery Balanced</th>
<th>Plexus Wealth BCI Balanced A</th>
<th>PSG Balanced A</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allan Gray Balanced A</td>
<td>100%</td>
<td>90%</td>
<td>85%</td>
<td>64%</td>
<td>80%</td>
</tr>
<tr>
<td>Coronation Balanced Plus A</td>
<td>90%</td>
<td>100%</td>
<td>91%</td>
<td>74%</td>
<td>86%</td>
</tr>
<tr>
<td>Discovery Balanced</td>
<td>85%</td>
<td>91%</td>
<td>100%</td>
<td>70%</td>
<td>82%</td>
</tr>
<tr>
<td>Eq Balanced Portfolio</td>
<td>92%</td>
<td>97%</td>
<td>96%</td>
<td>84%</td>
<td>90%</td>
</tr>
<tr>
<td>Plexus Wealth BCI Balanced A</td>
<td>64%</td>
<td>74%</td>
<td>79%</td>
<td>100%</td>
<td>65%</td>
</tr>
<tr>
<td>PSG Balanced A</td>
<td>80%</td>
<td>86%</td>
<td>82%</td>
<td>65%</td>
<td>100%</td>
</tr>
</tbody>
</table>

These managers are not perfectly correlated, as correlations are less than 100% (or +1)

A very basic equally weighted strategy has therefore improved risk-adjusted performance significantly. This is not a random outcome, but a mathematical certainty.

**SHARPE RATIO**

<table>
<thead>
<tr>
<th>Portfolio name</th>
<th>Return</th>
<th>Volatility</th>
<th>Sharpe Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foord Balanced R</td>
<td>14.4%</td>
<td>6.2%</td>
<td>1.39</td>
</tr>
<tr>
<td>Momentum Balanced R</td>
<td>13.2%</td>
<td>6.0%</td>
<td>1.24</td>
</tr>
<tr>
<td>Old Mutual Balanced R</td>
<td>13.5%</td>
<td>6.3%</td>
<td>1.22</td>
</tr>
<tr>
<td>Prudential Balanced A</td>
<td>15%</td>
<td>6.4%</td>
<td>1.45</td>
</tr>
<tr>
<td>SIM Balanced R</td>
<td>12.8%</td>
<td>6.4%</td>
<td>1.11</td>
</tr>
<tr>
<td>Average of five managers</td>
<td>13.8%</td>
<td>6.3%</td>
<td>1.28</td>
</tr>
<tr>
<td>Equally Weighted Portfolio</td>
<td>13.8%</td>
<td>6.1%</td>
<td>1.32</td>
</tr>
<tr>
<td>FMP Equally Weighted Portfolio</td>
<td>14.2%</td>
<td>6.0%</td>
<td>1.40</td>
</tr>
</tbody>
</table>
You might ask why not just buy the manager with the best historical performance. The answer is quite simple, five years ago an investor would not have known which single managers would be the top performer in the subsequent five year period. The only certainty five years ago would have been the fact that combining managers would have resulted in better than average risk-adjusted returns.

An overview of the STANLIB Multi-Manager approach

STANLIB Multi-Manager does not simply invest naively (both equally weighted and every manager/fund) in single managers. Single managers are carefully selected (through a rigorous qualitative and quantitative manager research process) and expertly blended to achieve good diversification and excellent risk-adjusted returns.

Every single manager is different, even though there could be overlap on parts of their investment philosophy and process. While some single managers employ forward looking strategies (e.g. estimating future cash flows), others focus more on historical information (e.g. historical P/E ratios), and others utilise a combined approach (e.g. P/E ratios based on forward consensus earnings). This is only part of what makes managers different and managers may construct portfolios to have exposure to many different risk factors (e.g. rand or interest rate sensitive or defensive companies). These factors can play a critical role in driving a single manager’s performance. Not all investment philosophies and processes will perform well at all times, and it is important to understand which strategies have the best chance of outperforming over the longer term. As illustrated above, when managers are not perfectly correlated, diversification benefits are realised by blending them.

STANLIB Multi-Manager utilises qualitative and quantitative techniques to determine whether a manager is likely to be skillful going forward and how their portfolios are likely to behave in isolation and in relation to each other. They use this information to select and blend local and international single managers into funds that will offer excellent risk-adjusted returns.

Qualitative analysis includes a thorough understanding of the single managers’ investment philosophy, process, and people, which is gathered through on-going in-depth due diligence reviews and office visits.

Quantitative analysis incorporates various statistical tools, to measure and analyse risk and return numbers, and portfolio holdings over different time periods and in various economic environments. Although managers are considered in isolation, they are also always considered relative to benchmarks and their peers.

By investing in a STANLIB-Multi Manager fund, an investor gets the best of both worlds – access to leading single managers and a well-diversified single packaged solution, resulting in excellent risk-adjusted returns.
The enhanced diversification potential in global markets

By Kent Grobbelaar, Head of Portfolio Management (Offshore), STANLIB Multi-Manager

When researching this topic, one cannot help but also ask related questions, such as: how much you should invest offshore, where and with whom?

In this article, I will try to address some of the issues which come up when looking at the diversification benefits of offshore investing, however one should be mindful of the fact that everyone is different. Circumstances change, attitudes to risk differ and individual goals vary. As such there is no such thing as one size fits all. I will therefore draw on personal experiences but also express STANLIB Multi-Manager’s best investment view to assist our clients in making informed decisions.

It’s not all about the base (currency)

I was born in 1974. Since then the rand has lost 94% of its value against the dollar (in nominal terms). It would therefore come as no surprise most people would list hedging against further currency depreciation as one of the greatest benefits of investing offshore. In some instances it is those very same people who may have recommended investing in BRICS (Brazil, Russia, India and China). This was after all the fastest growing countries with favourable population dynamics and which didn’t suffer from the indebtedness of many of their developed market counterparts. The fact that the Russian rouble and Brazilian real depreciated by more than the rand over the last 5 years highlights the importance of, “where” in the equation. Suffice it to say the reasons for the rands’ plight such as political risk and commodity sensitivity are well documented so there is no need to elaborate further. The point is: given the constraints as a result of exchange control, one should maximise the diversification potential through investing in uncorrelated assets and a weak rand is only a part of a broader consideration.

The world is your oyster

Almost 20 years ago I started my career in the offshore division of what was then Standard Bank Fund Managers. This coincides with the relaxation of exchange controls and much has happened during my tenure with the group. Throughout the period though, I would say one of the biggest lessons learnt was how broad the opportunity set to invest offshore is. Forget currency and makeup of the JSE for a second. Imagine for a minute you were the head of Jupiter’s Sovereign Wealth Fund. You’re looking at planet earth and deciding where to invest. I suspect from the map below you would not allocate much more than say 5% to South Africa. It illustrates how small our economy is relative to the market capitalisation of some multinationals and it is these companies, rather than South Africa Inc, which will probably attract your attention.
If you were the Chief Investment Officer of said fund, another way of looking at this would be to consider SA equity and bond markets relative to the rest of the world. When viewed in this context it becomes clear a home bias really and truly limits what you can invest in. We represent a mere 0.2% of global debt indices with only 60 securities out of 20 708 in the broader Barclays Multiverse index. Similarly, we pale into insignificance in the equity space – see below.

### Table: BOND

<table>
<thead>
<tr>
<th></th>
<th>Global (Barclays Multiverse)</th>
<th>South Africa</th>
<th>Weight</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of securities</td>
<td>20 708</td>
<td>60</td>
<td></td>
</tr>
<tr>
<td>Market cap (US$)</td>
<td>46.04T</td>
<td>0.09T</td>
<td>0.20%</td>
</tr>
</tbody>
</table>

### Table: EQUITY

<table>
<thead>
<tr>
<th></th>
<th>Global (MSCI AC Investable Market Index)</th>
<th>South Africa</th>
<th>Weight</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of securities</td>
<td>8 674</td>
<td>111</td>
<td></td>
</tr>
<tr>
<td>Market cap (US$)</td>
<td>47.78T</td>
<td>0.30T</td>
<td>0.63%</td>
</tr>
</tbody>
</table>

Source: MSCI, Bloomberg, Barclays

A more efficient frontier

Having spoken to many clients over the years it’s been apparent SA investors are woefully underweight in offshore assets. If diversification is sound for a nation whose stock markets represent half the globe’s market cap (USA), how much stronger is the argument for SA investors where the JSE is a mere 0.63% of the investable universe? Put differently, we believe the 25% permissible offshore within pension funds is not sufficient diversification (bearing in mind most of an individual’s net worth is probably in their house and other local assets). To help articulate the point, take a look at the next two graphs. The first is a frontier highlighting various combinations of domestic equity and bond portfolios using historic returns over the past two decades.
Should foreign equities and bonds be included, we would only observe a diversification benefit if portfolios generated superior returns, lower risk or both. We assess this by calculating real rand returns versus real risk as measured by annualised standard deviation of real returns, also known as volatility. If the return per unit of risk rises when adding foreign assets, the portfolio is being enhanced. The second graph shows a frontier with the inclusion of both foreign and domestic equities and bonds. By doing this, it’s clear one experiences greater risk reduction, higher returns and therefore more efficient portfolios.

**Idio(t)syncratic risk**

We believe it does not make sense taking on risks which are easily diversifiable. To this end another problem facing local investors is that certain sectors are not well represented in SA. Using Information Technology (IT) as an example, SA simply does not have the depth and variety of technology companies available to American and European investors. Other sectors which are either virtually non-existent or poorly developed are healthcare and utilities. Within the aforementioned sectors there are also concentration issues at security level i.e. the table below underlines the fact that almost half the SWIX is made up of ten shares. Conversely broader global indices are much more diversified. Kindly note this is not a SA or Emerging Markets (EM) problem. For those of us whose first cell phone was a Nokia, you might remember at its peak, the mobile company accounted for around three quarters of the Helsinki stock exchange (and we all know how that ended).
Similarly resources accounted for over half the FTSE/JSE All-Share Index in 2008. It therefore seems intuitive to invest in a global universe which mitigates concentration risk.

<table>
<thead>
<tr>
<th>TOP 10</th>
<th>SWIX</th>
<th>MSCI AC IMI</th>
</tr>
</thead>
<tbody>
<tr>
<td>Naspers</td>
<td>13.8</td>
<td>1.4</td>
</tr>
<tr>
<td>British American Tobacco</td>
<td>5.4</td>
<td>1.0</td>
</tr>
<tr>
<td>Sasol</td>
<td>5.3</td>
<td>0.9</td>
</tr>
<tr>
<td>SABMiller</td>
<td>5.1</td>
<td>0.7</td>
</tr>
<tr>
<td>MTN</td>
<td>5.1</td>
<td>0.7</td>
</tr>
<tr>
<td>Steinhoff International</td>
<td>4.5</td>
<td>0.6</td>
</tr>
<tr>
<td>Standard Bank</td>
<td>2.9</td>
<td>0.6</td>
</tr>
<tr>
<td>FirstRand</td>
<td>2.9</td>
<td>0.6</td>
</tr>
<tr>
<td>Remgro</td>
<td>2.4</td>
<td>0.6</td>
</tr>
<tr>
<td>Richemont</td>
<td>2.3</td>
<td>0.6</td>
</tr>
<tr>
<td></td>
<td>49.5</td>
<td>7.7</td>
</tr>
</tbody>
</table>

Conclusion

We believe investors should be looking at a broad range of benefits provided by offshore investments. Hedging against currency depreciation should not be the sole purpose. Spreading assets across several countries as well as accessing opportunities in sectors and companies which may not be available locally, just makes sense. Our status as an EM tends to make our exchanges more volatile than first world bourses and this is sometimes compounded by factors difficult to forecast like drought or politics.

A word of caution however – the next ten years may look very different to the past ten. The rand is considered one of the most undervalued currencies in the world. Any strength from current levels will undoubtedly have an adverse impact on future returns of non SA assets. While it’s notoriously difficult to forecast the rand, it’s worth highlighting it has historically bounced back from such extreme/oversold levels. To put it into perspective, I met up with colleagues after work and was amazed how cheap alcohol (and Big Macs) was in SA. This got me looking on Google where I found a survey on the cost of beer in a neighbourhood pub, which is cheaper in Johannesburg than anywhere in the world! According to www.expatistan.com a pint only costs a quarter of an equivalent beverage in London. I can endorse this survey and verify its accuracy so you can either drown your sorrows because the rand is weak or enjoy the quality of life. Either way a prudent approach to investing offshore from current levels would be to follow a staggered approach to increasing exposure.
STANLIB
Multi-Manager
Diversification beyond asset classes