Multi-Balanced Model: Your Questions Answered

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In July 2014, Benefits Magazine published my article "Multi-Balanced Model: The Missing Link in Investment Approaches?" Since publication I have been contacted by several plan sponsors asking for greater detail on the "nuts and bolts" of actually implementing a multi-balanced manager (MBM) investment strategy.

This paper will address the most common questions. Before reading this paper, I highly recommend you clicking on the link above to read the original article that compares and contrasts the MBM model and the consultant-centric model in common use today.

Institutional plan sponsors are continually looking for ways to improve their investment process. A multi-balanced manager (MBM) investment strategy offers many advantages over the consultant-centric model in widespread use today. These include:

- Asset Allocation Strategy Diversification
- Manager Selection Diversification
- Rebalancing Diversification
- Tactical Asset Allocation Diversification
- Real-time Rebalancing
- Lower Fees
- Ease of Monitoring
- Shorter Meetings
- Greater Fiduciary Protection

It should follow that a lower-cost, diversified, dynamic and real-time investment process will lead to superior results over the long-term. Further, there are non-performance benefits regarding the administration that should have appeal to every plan sponsor.

Below I address the most common questions and explore options in implementing the MBM model.

<u>Do other institutional plan sponsors follow the MBM model?</u>
Multi-Balanced Model is my name for an investment strategy that utilizes multiple balanced managers that follow the same broad investment guidelines. Each balanced manager executes their strategies *independently* to achieve diversification of the key investment decisions normally made by a lone investment consultant.

This strategy is quite common overseas and is gaining popularity in America with more and more institutional investors making the switch. Domestically this is often referred to as "Multi-OCIO," "Multi-Asset Class Portfolios," "Customized Solutions," etc.

<u>What level of assets is needed to implement the MBM?</u>
The MBM model can be implemented by any size plan. Like with any strategy, economies of scale can make it even more appealing as costs will necessarily be lower for larger plans. Based on surveys of qualified balanced managers, it appears the minimum mandate size should be $100M.

<u>How many balanced managers should we hire?</u>
Using just a single balanced manager provides the same level of diversification for the high level decisions of asset allocation, manager selection, tactical asset allocation and rebalancing as the consultant-centric model. Each additional balanced manager will diversify these key decisions.

The trade-off between the number of balanced managers concerns fees and "over-diversification." With more managers having an equal share of assets, the mandate size will decrease and fees will be higher.

The "right" number of balanced managers to hire cannot be objectively determined and requires judgment. Although two balanced managers indeed create diversification, there is still manager concentration. So the number should be higher with the limit guided by the trade-off in fees. I suspect the optimal number to be three, four or five balanced managers.

What might our Investment Policy Statement look like?

Once the decision has been made to implement the MBM model, the most important step is to craft an investment policy statement (IPS) that will be *followed by each balanced manager*. The key differentiator between an IPS for the MBM model and a consultant-centric IPS is that the asset allocation ranges are generally wider. This grants each balanced manager discretion. This is the primary benefit of the MBM- *diversifying strategy within the asset allocation function.*

It should be emphasized that even if a consultant-centric IPS has wide asset allocation ranges, the execution of the asset allocation strategy *remains concentrated*.

Last year (2014) I worked closely with nearly a dozen such balanced managers exploring acceptable asset allocation ranges to achieve a 7.5% long-term return, net of fees. Below is the consensus asset allocation policy believed to allow enough flexibility to achieve the objective over the long-term:

Asset Allocation Guidelines

		Min.	Max.
Equities			
Domestic Equity		15%	45%
	Small/Mid Cap =< 20%		
International Equity		15%	35%
	Emerging Mkts =<15%		
Fixed Income		20%	70%
	Below Inv. Grade =<20%		
	Foreign =<15%		
Liquid Alternatives		0%	15%
	REITS =<10%		
	Commodities =<10%		
	HFOF =<10%		

Other matters such as credit quality, leverage, securities lending, liquidity and security weighting limits would also need to be addressed in the IPS.

How would the balanced managers invest the assets?

Following the IPS, collective trusts, ETFs and possibly mutual funds would likely be utilized.

What about alternative investments?

The sample asset allocation strategy above assumes the use of *liquid alternatives*. Illiquid alternatives may still have a place in your overall strategy. The most common such illiquid alternatives are private equity, distressed credit and infrastructure. Pooled real estate may also fall into this category. If a plan has existing illiquid alternatives, it must be determined whether to hold or sell. If they are held, an alternatives manager or consultant should be charged with overseeing these particular assets and the liquid alternatives range in the IPS may thus require adjustment.

What will be our investment consultant's role following the MBM strategy?
Although the key investment consultant decisions are delegated to the balanced managers, there is still need for the services of investment consultants. These duties include:

- Balanced Manager Selection and Monitoring
- Rebalancing Among the Balanced Managers
- Cash Flow Management
- Performance Reporting
- Illiquid Alternative Selection and Monitoring
- Investment Policy Statement

Similar to the consultant-centric model, a plan sponsor may choose a "master consultant" to oversee the MBM model and the duties listed above. However, consideration should be given to separating some of these duties. Specifically, an additional consultant may be added to serve as an illiquid alternatives consultant. An investment consultant may also be hired to serve strictly as a performance monitor. Such separation will ensure greater transparency and reduce conflicts of interest.

How might our Investment Policy Statement change over time?
Although the IPS asset allocation ranges are broad, they may still occasionally need adjustment due to new investment opportunities and/or changes in return expectations. If following a consultant-centric model, the asset allocation ranges would be adjusted by a lone consultant. Following the MBM model, the balanced managers would also participate in this decision so that there is greater diversification of thought in making changes to the asset allocation ranges or changing the allowable asset classes.

Will there be active or passive investment strategies?
Many plan sponsors have an ongoing debate whether to use active or passive strategies. Quite often the solution is to index "efficient" asset classes and use active strategies for "inefficient" asset classes. Without getting into the merits of the debate, use of the MBM model would delegate and diversify this decision among the balanced managers.

In my discussions with various balanced managers, most of them can do an all-active or all-passive strategy. There are fee differences. However, most of the managers want discretion to use both, thus diversifying the active-vs.-passive decision. Regardless, plan sponsors should consider having at least one all-passive balanced manager.

How does performance monitoring change?
The first big difference is that there are fewer managers to monitor. Many plan sponsors have ballooned in the number of managers all managing against different benchmarks that may or may not be appropriate. Further, there will no longer be the deceptive practice of Benchmark Linking disguising an investment consultant's ability to add (or lose) value with their asset allocation decisions.

Each balanced manager will also be managing against the same benchmark- your long-term assumed rate of return. Further, since each balanced manager is following the same guidelines, the plan sponsor actually creates its own peer universe making performance comparison quite simple.

The MBM model will save time and create a more objective and transparent method for manager monitoring.

How do we manage cash flow following the MBM?
Cash flow management is often an after-thought, but this is a big mistake as there are trading costs associated with every movement. In the consultant-centric model using many specialty managers, cash flow is often divided proportionately among various managers in various asset classes. The monthly or quarterly movement of small percentages of each portfolio can create a silent drag on performance. This is a costly nuisance for many managers, too; especially the small ones in "inefficient" markets.

Following the MBM model, a single manager would be chosen for cash flow purposes. In the case of negative cash flow, the balanced manager with the most assets (due to relative outperformance) would be the source of funds. Conversely, in the case of positive cash flow, the balanced manager with the least assets would be the recipient. The choice of which asset class(es) to buy/sell would be diversified and create a buy-low and sell-high method within the cash flow function.

How do we rebalance among the balanced managers?
Similar to cash flow management, the rebalancing function could become an objective policy. The method would either be by time or by percentage of assets. For example, the rebalancing could occur annually among all the managers bringing them to parity. Or, if the difference between any two managers reaches 5%, rebalancing could occur between those two specific managers or all of them. Again, this creates an additional buy-low and sell-high discipline that is objective and automated.

How much cost savings should we expect?
Based on my research I expect the savings to be from 20% to 40%. There are many factors affecting the amount of savings. They are:

- Size of Plan
- Current Number of Active Managers
- Number of Balanced Managers
- Current/Future use of Passive Management
- Role and Number of Consultants
- Use of Illiquid Alternatives

The primary source of the savings comes from the increased size of mandates as opposed to using many specialty managers each managing a small piece of the total portfolio in a particular asset class.

What about total risk management?
Risk management is an important aspect to long-term investment success. The MBM model diversifies risk management from a lone investment consultant to several balanced managers. Following the consultant-centric model, it is possible to take too much risk at the wrong time. It is also possible to take too little risk at the wrong time. Because the decision is concentrated, it is not diversified.

The MBM model also poses these same risks. However, for all of the balanced managers to go to "one side of the boat" at the wrong time requires conviction from each and every one of those balanced managers. This is less likely following the MBM model. Further, each balanced manager is limited by the same IPS and careful attention must be focused on the construction of the asset allocation ranges to manage total plan risk.

Do we still need an investment consultant if we adopt the MBM model?
The key investment decisions following the MBM model are delegated and diversified among the balanced managers. Cash flow management and rebalancing can be objectively managed and defined in the IPS. Performance monitoring will be greatly simplified with relative performance simply being a comparison of the balanced managers and total performance would be a simple matter of adding up the returns and dividing by the number of balanced managers. Finally, asset allocation and updating the IPS would be a relatively infrequent exercise with participation by the balanced managers.

A strong case can be made that a *full-time investment consultant* would not be necessary. Instead duties could become project work, with performance and manager monitoring being an annual event.

How do we choose the balanced managers?
A plan sponsor would perform a manager search just like any other manager search and most likely led by an investment consultant. Special emphasis would be placed on internal capabilities, personnel, use and description of proprietary products, process and fees.

How do we transition assets from our consultant-centric strategy to the MBM model?
This would be a simple matter with the hiring of a specialized consultant and/or primary broker to coordinate and facilitate a seamless transition from the various specialty managers to the balanced managers.

Will our fiduciary liability be affected following the MBM?
A strong case can be made that the MBM can reduce a plan sponsor's fiduciary liability vis a vis the consultant-centric model. There are many reasons why this is true.

The first is that a plan sponsor will not have to make as many (delayed) decisions concerning asset allocation, manager selection and rebalancing. These decisions are delegated to the balanced managers to *execute in real time*.

The second is that there are fewer managers to monitor. Following ERISA, DOL guidelines and judicial precedent, plan sponsors must know what they are invested in and who is managing the plan's assets. Can a plan sponsor effectively monitor 20+ different specialty managers? Following the MBM, a plan sponsor can go into substantive depth with each balanced manager to fulfill their fiduciary duty to understand their investments and the investment process- it is much easier.

The third is that fees will be lower and plan sponsors have a duty to seek competitive fees.

The fourth concerns investment consultant monitoring. Following the consultant-centric model, the invesmtent consultant's decisions are the primary driver of performance. But investment consultant reports are great camouflage that disguises the investment consultant's ability to create value. Read Decoding Investment Consultant Alpha to learn more about this near impossibility.