April 2016

Common Pitfalls Advisors Should Avoid When Building Multi-Manager Portfolios

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With a vast amount of investment products and strategies, it could be particularly tempting to combine together several strategies that look great hypothetically going backwards. While this can make some sense in a traditional "stock" and "bond" portfolio where the academic "non-correlation" of a "zigging" stock and a "zagging" bond becomes a trained assumption, a composition of different *strategies and styles* can introduce a lot more complexity. When it comes to multi-strategy implementation, there should be a centralization of portfolio planning and construction. Economists would call it the "central planner," and football players would call it the "quarterback." Without a solid game plan and an overarching manager constantly monitoring to make sure that all the pieces of a portfolio properly fit together, we believe advisors looking for "quick" investment solutions can be especially vulnerable to several mistakes that can derail an investment portfolio from its intended purpose. We refer to these mistakes as common pitfalls advisors should avoid:

1. Not having a cohesive investment message or goal

We believe one of the most important starting points to any portfolio construction is having the investment objective and philosophy explicitly planned. When attempting to pull together several ideas, commentaries, risk and return expectations and targets from multiple strategists with potentially conflicting views and philosophies, it may become difficult to build one confident investment message to build comfort with clients. Not having a solid plan can also have negative effects in the live management of the investments. Common questions including, *"What is the maximum amount of any one asset class, any one style, any one strategy? What is the research process to include, or remove a manager? What are the risk and return targets of each portfolio and how do they fit with my client's profile? What is the general investment philosophy? What is the theme of the investments to communicate to my client?"* should all be answered and outlined beforehand.

2. Having the wrong type of "diversification"

One of the keys to a successful investment portfolio, as we are all taught, is "diversification." But to be more detailed, a portfolio should have diversification in *non-correlated* strategies or asset classes. Though this concept is quite simple, we've all seen it before: an advisor finding the two "perfect" managers optimized in a portfolio for the best backward looking results only to find out that they both **do the same thing**. While splitting your eggs with two different managers in the same space may feel like you're diversifying, both managers may still be susceptible to the same types of risk. Trying to avoid these scenarios goes beyond performance analytics, and requires deeper due diligence, holdings analysis, quantitative attribution analysis, and constant reviews.

The Do Not's of Blending Strategies:

Figure. 1: Below shows an example of a portfolio of two similar managers to fill one risk bucket, like two tactical high-yield managers:

	Risk-On	Risk-Off	**BLEND RESULT**
Manager 1	High-Yield	Cash	**1x High Yield**
Manager 2	High-Yield	Cash	**1x High Yield**
BLEND RESULT	**2x High Yield**	**Cash**	

As seen in Figure 1, three out of four outcomes result in potential unintended allocations. For example, during times when Manager 1 is risk-off and Manager 2 cancels out the strategic efforts Manager 1. More importantly, during times when both managers are risk-on, a portfolio can have twice the amount of high-yield exposure, and much higher risks. The same can be said for blending managers with overlapping asset allocations such as two managers who can invest in the Nasdaq-100. Overlapping allocations such as these are warning signs of unwanted risks.

3. Focusing and reviewing the wrong type of performance

With most investors being long-term focused, reviewing the wrong time-frame with clients can be a recipe for disaster, potentially leading to second guessing of your manager selections. This could motivate short-term focused portfolio modifications and constant manager turnover without proper research and reasoning, ultimately leading to disappointing results and corrosion of investor confidence. For example, just because backwards looking calendar years look great, doesn't mean the client will have the same experience going forward. Rolling time periods can help illustrate the range of what portfolio returns might look like at any point in time, thereby setting more realistic expectations.

4. Over optimizing and allocating to the wrong types of risk

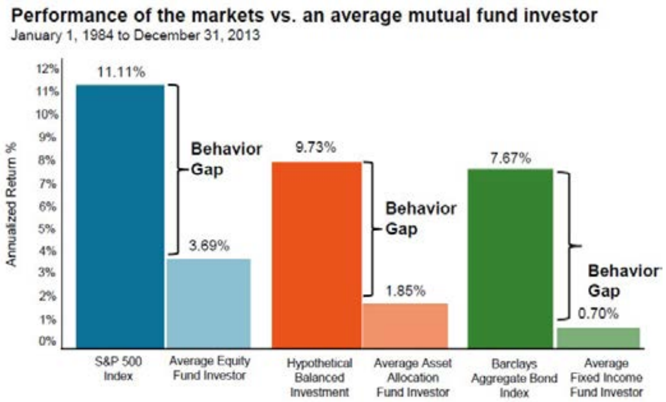
Technology and databases available today offer a variety of tools that can aid in portfolio construction. Advisors, however, should be especially careful when selecting managers using backward looking data and portfolio tools. Without fully understanding the purpose of different strategies and compositions, it can be easy to fall into the trap of over optimizing a portfolio for best returns using backward looking data. The result could be overstated returns and understated risk, leading to the misalignment of return and risk expectations. If picking the top 10 performing stocks of "last year" created the best results, there wouldn't be any need for investment professionals (we wish it was that easy!). If it doesn't work for stocks, why would it work for managers? Be careful when using software to blend together managers. While it helps give an impression of what a portfolio may look like, advisors should not only model out returns, but should also take into consideration mandates, asset classes used, asset class flexibility, and the overall purpose of strategies used.

5. Not monitoring investment risk regularly

"I built this allocation for the long-term, therefore I don't need to check it too often." Certainly the previous thought should apply to a "long-term" investment outlook, but it is important to monitor portfolios to identify attributions of returns *and losses* that can be applicable in different investment environments. Portfolios should be monitored and potentially tweaked within guidelines to make sure they are headed toward their intended targets. Having a "finger on the pulse" of your client portfolios can help build strong confidence for client messaging.

6. Letting emotions impact important investment decisions

At the end of the day, investing involves risking money, and losing money can get emotional. Newsletters, sentiment, and events can all create a positive or negative bias that can turn a "great idea" into a portfolio allocation change. Without proper research, these ad-hoc discretionary changes can move a portfolio further away from its intended goal, not closer. A series of studies conducted by Dalbar, Inc, commonly referred to as the "Dalbar Studies" illustrates that "the average investor earns less – in many cases much less" than mutual fund and benchmark performance.



Source: Dalbar. For Illustration Purposes Only. Data as of 12/31/2013.

The study shows that this can be attributable to poor investor timing and decisions. More than often, after disappointing losses, investors tend to make changes to their allocation to what has performed better in the same time frame (see # 4). Investors aren't the only ones at risk of ill-timed choices. Without proper understanding of strategy expectations and a disciplined investment management framework, advisors or their advisory firms are susceptible to irrational "performance chasing" as well. Advisory *firms* also run the risk of emotional investing, potentially suggesting manager allocation changes with poor timing. Portfolio allocation changes should have a disciplined, researched approach to avoid impromptu decisions caused by irrational emotions.

7. Not having full control of the asset allocation – lacking customization of portfolios

Nobody can predict the future and no one can control what the market will provide. Thus, you should be able to take actions to shape expected risk and returns of a portfolio. However, allocating to multiple strategies through multiple managers can limit flexibility to effectively customize a portfolio to its determined goal. For example, you may find a particular tactical strategy necessary in a portfolio that trades small cap equities. Without full control on a holdings based level, you may be forced to make a decision to either have none, or have double the exposure that you may have intended.

While investment management isn't exactly quantum physics and there is never a perfect process, we believe a qualified team that invests significant time and efforts, and conducts research informed by a combination of decades of investment experience and deep quantitative analysis, can enhance investor outcomes. At Redwood, our team of dedicated and experienced investment professionals, working in conjunction with professional marketers and advisors who understand their clients' needs, construct and manage our asset allocation portfolios. Our analysts and portfolios managers specialize in equity, fixed-income, tactical, and strategic implementations, working and communicating with each other to construct and manage our turn-key portfolios, each seeking to achieve desired results within a prescribed risk budget in a single cohesive way.

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