Multi-manager diversification myth exposed

By Joshua Ausden 19 Oct 2011

As well as underperforming their single-manager counterparts over the last five years, multi-manager funds have also proven to be more risky.

The vast majority of multi-manager funds are more volatile than their single-manager counterparts in the short-, medium- and long-term, and perform worse during falling markets, the latest *FE Trustnet* study has revealed.

Although one of the major selling points of multi-manager funds is their high level of diversification, our research shows that most fail to preserve their capital as effectively as traditional funds.

Of the 50 multi-manager funds in the IMA Active Managed sector with a long enough track record, only seven – or 14 per cent – have been less volatile than their sector average over a five-year period.

Over three years, only 20 per cent of the 69 multi-manager funds have been less volatile than their IMA Active Managed sector, while 21 per cent have been less volatile in the past 12 months.

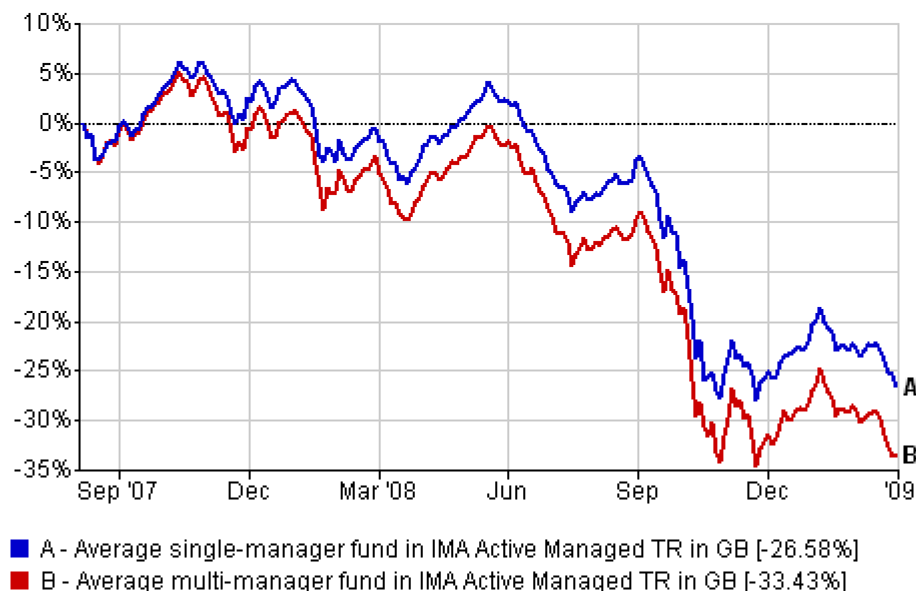
To put this another way, the average Active Managed multi-manager fund is around 1.6 per cent more volatile than its single-manager equivalent over three- and five-year periods.

As well as being more volatile, multi-manager funds also perform worse than single-manager funds in the long-term – especially in down markets.

Our data shows that the average Active Managed multi-manager fund has returned 5.15 per cent in the last five years – less than half as much as the average single-manager fund in the sector.

While higher management fees contribute to this underperformance, their failure to preserve capital in falling markets has also had a significant affect.

Performance of average Active Managed funds during credit crunch



Source: FE Analytics

According to *FE Analytics* data, from 8 August 2007 when credit markets froze, to the start of March 2009 when markets bottomed out, the average multi-manager fund in the IMA Active Managed sector lost nearly 7 per cent more than the average single-manager fund.

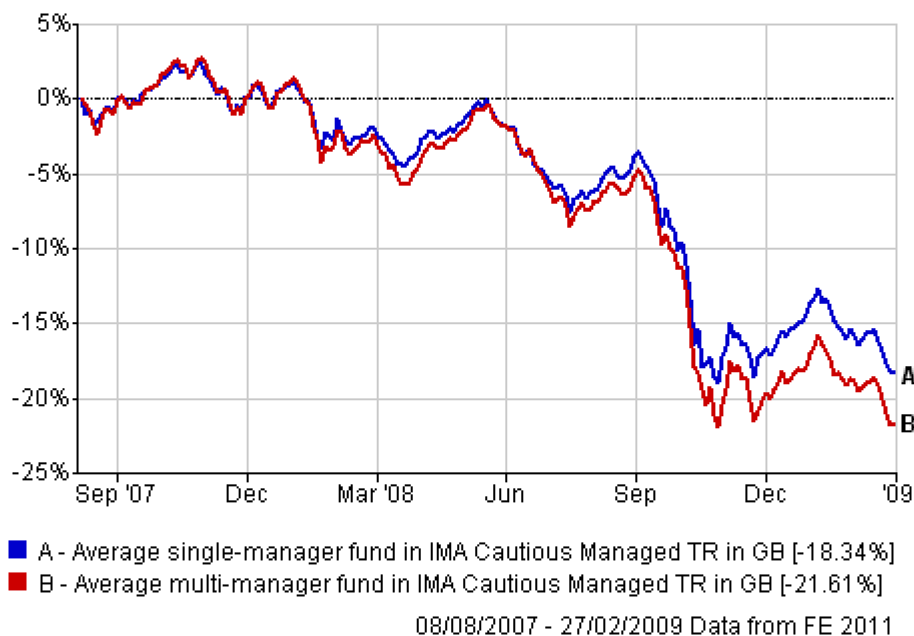
So far in 2011 the average Active Managed multi-manager fund has lost 1 per cent more.

There is a similar trend in the IMA Cautious Managed sector. Of the 42 multi-manager funds with a long enough track record, only eight – or 19 per cent – were less volatile than their sector average over a five-year period.

Over three years 22 per cent were less volatile, while over one year the figure is 25 per cent.

Cautious Managed multi-manager funds also underperform their single-manager counterparts in falling markets. According to *FE Analytics* data, the average multi-manager in the sector lost 21.61 per cent between 8 August 2007 and 1 March 2009, underperforming the average single-manager fund by 3.27 per cent.

Performance of average Cautious Managed funds during credit crunch



Source: FE Analytics

Single-manager funds have also lost 1.33 per cent less so far in 2011.

Rob Morgan, senior adviser at Bestinvest, says many multi-manager funds have failed to live up to their reputation of being good diversifiers.

"We have seen a huge amount of volatility in the markets in recent years, which hasn't lent itself to multi-manager funds," he said.

"A lot of these multi-managers exclusively own long-only funds, which do not provide adequate diversification. A basket of commodities, equities and even high yield bonds have a very high degree of correlation to one another, so investors aren't properly protected [against the downside]."

Morgan says multi-managers need to look beyond traditional long-only vehicles in order to maximise diversification.

"Gold has proven very effective, as have gilts and some hedge-fund strategies," he added.

Adrian Lowcock, senior analyst at Bestinvest, is of a similar opinion.

"The whole point of multi-manager funds is to minimise risk by diversifying your portfolio," he said. "However, this clearly is not the case."

"A big proportion of multi-manager funds are very dated. While they claim to be well-diversified, long-only funds dominate their portfolio, when really they should be holding a basket of different investment tools – for example ETFs, hedge-funds, listed and unlisted property and so on."

"It's the funds with a multi-asset approach rather than a multi-manager approach that have done best," he added.

Lowcock points to the £1bn Jupiter Merlin Balanced Portfolio as an example of an effective multi-asset fund. Unlike the vast majority of multi-manager funds in IMA Balanced Managed, it's less volatile that its secor average over one-, three- and five-year periods.