GREAT-WEST INVESTMENTS™

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Maestro, if you please...

Combining differentiated managers within a single asset class can increase consistency of returns

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- We believe that using multiple (and differentiated) investment managers within an asset class can potentially increase return consistency and improve investment outcomes.
- Utilizing multiple investment styles within the same asset class can create small but persistent differences in performance that may help increase portfolio efficiency.
- However, extensive due diligence is necessary — like a master conductor, asset allocators need to carefully assemble the orchestra to achieve the right harmonic balance.

Diversification is one of the most fundamental axioms of investing. But what if its traditional application — namely, simultaneously investing in dissimilar asset classes such as stocks, bonds and real estate to boost portfolio efficiency — is too narrow? Would it make sense, for example, to also differentiate within an asset class by allocating to multiple managers with differing investment approaches and characteristics? Our view is yes, it is in fact possible to improve investment outcomes by utilizing differentiated managers within the same asset class.

Achieving harmony by identifying differentiated voices

The logic is as simple as it is compelling. Within a given asset class, there are nearly as many ways to generate returns as there are investment managers attempting to generate them. Different managers may deploy vastly different investment processes, such as fundamental or quantitative, active or passive, bottom-up or top-down, or any number of iterations in between. But even within each of these broad subcategories, management styles can vary widely, often giving rise to persistent factor exposures that can translate into vastly different portfolio characteristics — and therefore vastly different returns. The implication is that consistent and measurable differences in performance may become evident, even across managers within the same asset class who on the surface appear to have very similar investment processes.

Investment styles, exposures and characteristics all differentiate strategies in the same asset class

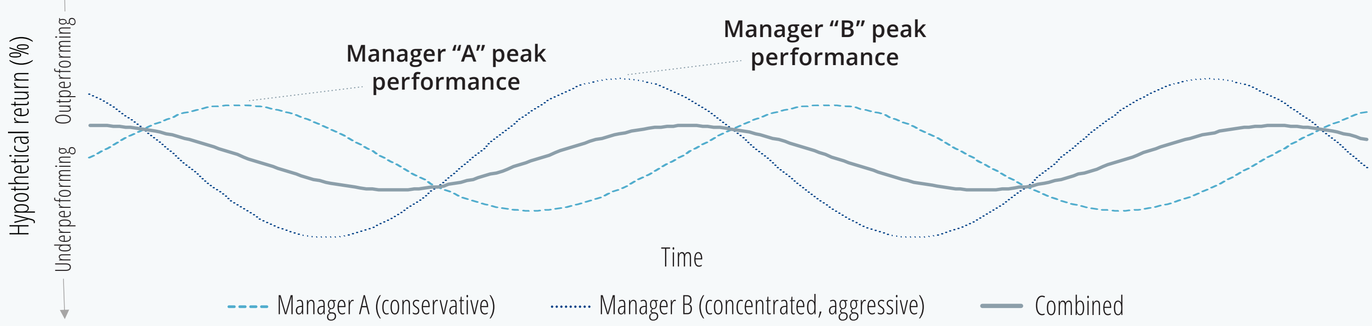
INVESTMENT STYLE	FACTOR EXPOSURE	CHARACTERISTICS
Passive	Liquidity	Tracking error
Smart beta	Momentum	Beta
Quantitative	Quality	Active share
Fundamental	Size	Concentration
Bottom-up	Yield	Sector deviations
Top-down	Volatility	Number of holdings
	Style	
	Currency	

At an even more basic level, it goes without saying that even the best single managers can experience periods of significant underperformance. But by combining multiple high-quality managers that tend to outperform at different points in the cycle, the overall consistency of returns can be improved, potentially boosting the risk-return profile of the entire allocation. As an added benefit, such consistency of returns may help encourage investors to remain invested through difficult markets, helping to thwart one of the most damaging tendencies in behavioral finance — specifically herding behavior (and the temptation to try and time the market that often comes with it).

Utilizing a multi-manager framework to achieve greater return consistency

In an effort to validate these ideas, we conducted a series of back tests that compared single-manager strategies and randomly generated multi-managed strategies within single asset classes — illustrated by small-cap value equity during a 10-year performance window ending December 31, 2020. Then, we extended the analysis to multi-managed strategies constructed specifically with intra-asset class diversification in mind by pairing managers who displayed a low correlation of excess return within single Morningstar peer groups.[1,2] We find evidence that this third set of portfolios — which combines differentiated managers in the same asset class in a thoughtful, deliberate way — displays superior risk-return characteristics over the other hypothetical portfolios tested.

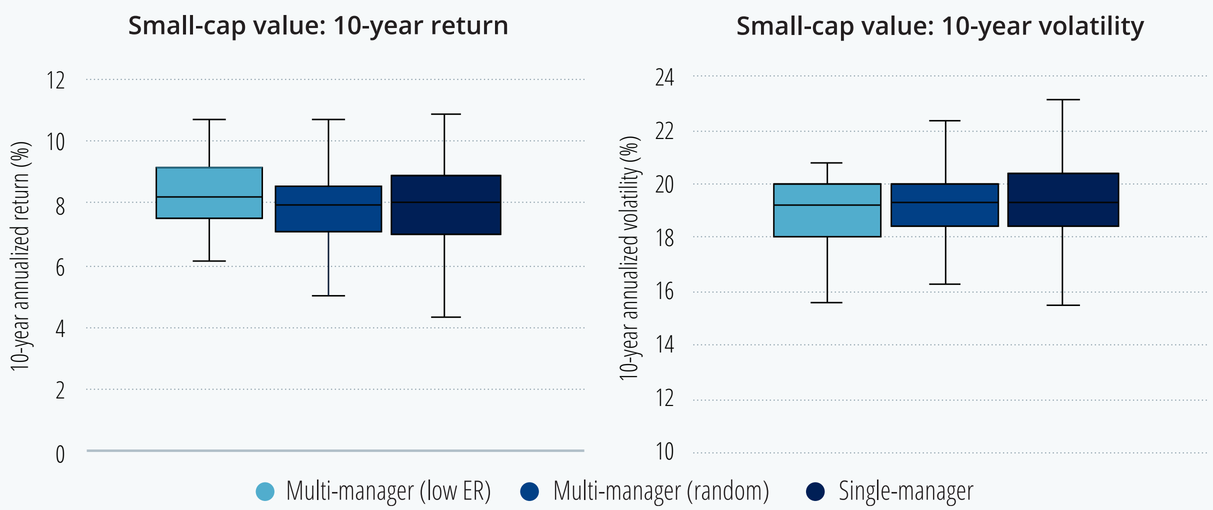
Sum of the parts: Combining differentiated investment managers



As expected, single-manager strategies displayed a wide dispersion of returns across the sample set, with a difference of more than 600 basis points between top- and bottom-performing strategies over the 10-year sample period (as seen in the chart on page 3). This result is hardly surprising and is very likely a mere reflection of the wide diversity of management styles utilized by the range of managers included in the sample set.

Next, we randomly selected pairs of managers from this set and assigned each an equally weighted 50/50 allocation within each pair, generating a second set of randomly paired portfolios. As expected, the range of outcomes for these randomly selected pairs compresses relative to single-manager portfolios, and volatility declines slightly. The return profile, however, is largely unchanged.

While this reduction in risk is a potential advantage over single-manager portfolios, it seems likely that investors could more easily target this outcome explicitly by utilizing passive index funds or an active manager with a lower tracking error. However, the real benefit of the multi-manager approach occurs when the paired strategies exhibit different fundamental characteristics, which in turn leads to a tendency to out- or under-perform at different points in the investment cycle. Therefore, by limiting multi-managed portfolio pairings to only those that exhibit the lowest excess return correlation,[3] we found evidence suggesting that it is indeed possible to reduce volatility and increase return within a single asset class exposure by carefully selecting and pairing managers that exhibit a lower overall excess return correlation to one another. Said another way, what matters is not simply diversification for diversification's sake, but the thoughtful combination of managers who play to one another's strengths and weaknesses. Notably, we conducted a set of parallel analyses beyond small-cap value equity and found evidence suggesting that similar advantages might accrue to a multi-managed approach in a variety of asset classes. We strongly suspect these results would apply to varying degree in other areas of most investors' asset allocations as well, which presents an opportunity for further research into the topic.



Assembling the orchestra: Extensive due diligence required

Of course, this analysis is by no means meant to define a stand-alone investment strategy, nor does it imply that statistics like excess return correlation should be the only input into manager selection for a multi-managed portfolio. Rather, these results suggest that there may be tangible benefits to be had by diversifying within asset class exposures as well as across them, provided that ongoing and extensive due diligence with regard to each potential manager's personnel, process and investment philosophy takes place.

The goals of this effort are at least three-fold: first, to identify superior investment talent that is differentiated (and complementary) to managers currently utilized in the space; second, to allocate assets among each manager in such a way that appropriately balances the contribution each makes to overall returns; and third, to monitor all underlying managers on an ongoing basis to ensure that the underlying characteristics that make them complementary to one another do not decay over time. This is precisely the framework we follow when implementing multi-manager strategies across our product suite at Great-West Investments and we believe others may benefit from this approach as well.

1 Source: Morningstar, GWI calculations. Data as of December 31, 2020.

2 For illustrative purposes, results for small-cap value are presented here. We analyzed other asset classes with similar results including: small-cap growth mid-cap growth, large-cap growth, small cap value, mid-cap value, large-cap value, and emerging market equities.

3 The 36 pairings that resulted in the lowest excess return correlation were selected for this universe.

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