CONCENTRATED MULTI-MANAGEMENT

INTRODUCING A NOVEL APPROACH IN LONG-ONLY EQUITY INVESTING

When looking for long-term growth opportunities, many investors now avoid traditional, actively managed strategies in favor of passive products for their long-only equity exposure. In doing so, they are avoiding some additional risk but are also forgoing the opportunity for excess returns. Yet, a concentrated multi-managed approach holds the potential for higher returns, assuming the solution is truly active and the aggregate portfolio does not become over-diversified.

What is multi-management?

Multi-management is an investment approach which consists of combining multiple, specialized investment managers or funds, across different markets, asset classes or investment styles. The premise rests on the idea that by spreading one's investment across differentiated and complementary managers or funds, one can reduce risk without sacrificing returns. The practice has become a commonplace solution in the asset management and advisory business. In fact, any investor using more than one portfolio manager uses a multi-managed approach and most client solutions today, from retail investors to the largest pension funds, are constructed through some form of multi-management.

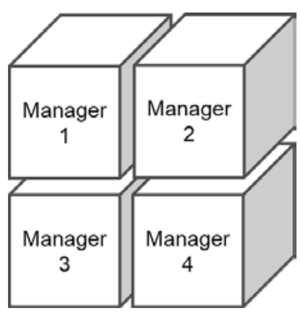
The popularity of multi-management rests mainly on its flexibility. Investors can tilt their overall exposure towards different markets, asset classes or investment styles allowing them to tactically respond to changing market environments and trends. A multi-manager approach also allows for a high level of diversification. History has shown that few managers have been able to outperform their benchmarks consistently across different market environments. By selecting managers that have complementary characteristics, a multi-managed approach allows investors to spread contributions and reduce risks. Performance of the multi-managed solution should be more consistent and less volatile since, if one manager struggles or if his or her style goes out of favor, the impact of their underperformance at the aggregate level should be minimized by the other, complementary managers.

However, a multi-manager construct also comes with its set of drawbacks. The first is the difficulty in identifying and selecting managers. Another oft cited issue is the incremental costs associated with implementing a multi-manager solution. We will address each of these points in subsequent white papers, but we believe that the greatest fundamental weakness of the traditional multi-manager approach is the over-diversification that often results from such an approach.

The traditional multi-manager approach

Figure 1, below, depicts a traditional multi-manager approach. In this example, the solution utilizes 4 different funds or managers, each employing a differentiated and (hopefully) complementary approach. For example, a US equity exposure might have allocations to a large cap value manager (1), a large cap growth manager (2), a small cap value manager (3) and a small cap growth manager (4). In theory, each of these managers is fishing in different ponds. When a style (e.g., growth vs. value) goes “out of favor “, two of the managers would be expected to struggle, while the other two should find themselves in a more favorable environment, balancing the overall contribution profile.

Figure 1. Illustration of a traditional multi-manager approach



Typically, each manager would invest in most, if not all, sectors of the market and could hold dozens or even hundreds of individual securities within its portfolio. Thus, when combined, the aggregate portfolio of a traditional multi-manager approach could conceivably hold as many names as the index even after accounting for some overlap in holdings amongst the selected managers. As a consequence, this “active” solution often ends up looking very similar to the benchmark that it’s trying to outperform. With active fees being levied on such a passive-like product, it’s no wonder investors are flocking to passive strategies, turning the active management industry on its head.

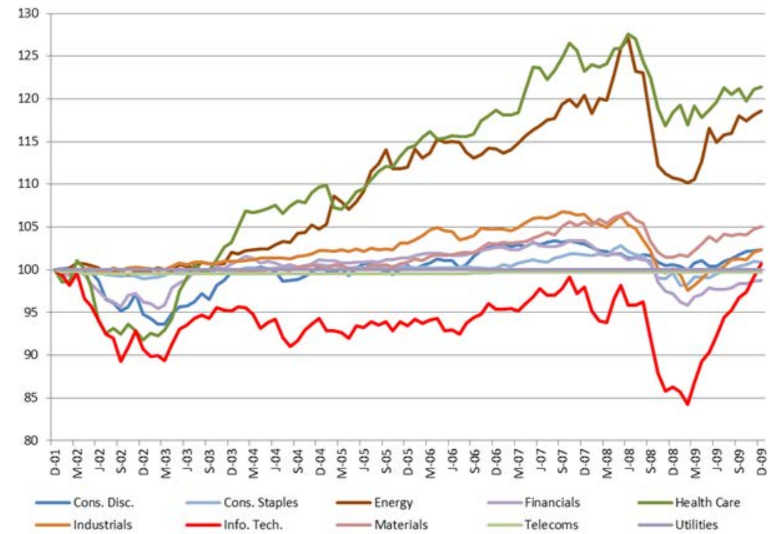
Some managers *can* deliver alpha

Most of the managers we focus on in our research practice fundamental, bottom-up stock-picking analyzing individual stocks, as opposed to sectors or industries. They focus on a specific company, its products and services, its fundamentals, its financial situation and its operating environment to determine whether or not that particular stock will make for a good investment. We’ve interviewed many managers who like to believe, or at least say, that they can find value “no matter where it is.”, that they are stock-pickers adept at analyzing companies and selecting those that are undervalued, regardless of which industries they operate in. We started our endeavor by testing this hypothesis: Is it true that bottom-up stock-pickers are able to find value anywhere?

Through our research, we discovered that this is not always the case. Rather, we have found that some managers are indeed able to consistently add value by picking stocks, but usually only in specific areas or sectors of the market. As a result, we believe sectors offer a better framework for evaluating manager performance for use in a multi-managed construct. Typically, managers are analyzed through a size/style prism which essentially coerces managers to constrain their investable universe to a particular size (large caps vs. small caps) and/or style (“growth” vs. “value”). This “style box” construct, which has become ubiquitous in the industry, is a somewhat arbitrary and ambiguous classification system. Classification of stocks by sector is much less fluid than by size and/or style, generating what we feel is a more robust analysis. Furthermore, differences between sectors are much clearer than the difference between “value” and “growth”. More importantly, some managers display biases in their stock-picking abilities, when isolating their work product by sectors, which aren’t evident when viewed through the traditional size and style lens.

In some cases, managers demonstrate consistent stock-picking ability within a specific sector. Our process is designed to identify these biases and a unique aspect of our approach is the way in which we evaluate managers. Most fund selectors and investment advisors rely on short-term attributions to assess the impact of individual holdings and sectors on the overall portfolio and understand near-term drivers of returns. Analyzing the expertise of a manager over a long timeframe by isolating sub-sections of the aggregate portfolio can lead to interesting and unexpected results.

Figure 2. Cumulative Contributions to Return of a Select Strategy (from December 2001 to December 2009)



Source: Morningstar Direct, JMCAM. The select strategy is a real existing composite from a third-party manager. The data above is shown for illustrative purposes only, calculated using monthly returns and based on month-end holdings provided directly by the manager. Past performance is not a guarantee of future results.

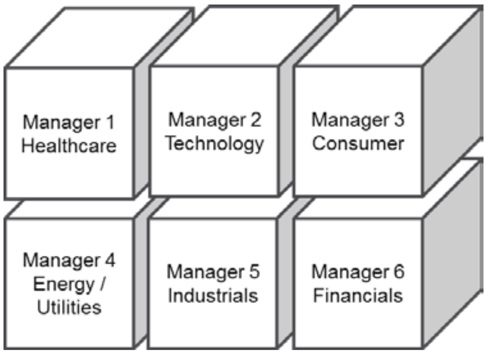
Figure 2 illustrates this point by showing the cumulative contribution to return of each sector for a select strategy over an 8-year timeframe. During that 8-year timeframe, the strategy as a whole handily outperformed both the S&P 500 and its style-specific benchmark. However, when looking at the drivers of that performance on a sector-basis, we see that, for this particular strategy, Health Care stocks, as a group, as well as the Energy sub-portfolio clearly contributed an outsized proportion of the overall return of the strategy. Conversely, stocks in the Information Technology sector substantially detracted in 2002 and in 2008 without adding much in the intervening years. Other sectors, as a whole, neither added to nor detracted significantly from overall performance.

Our process enables us to better assess a manager's stock picking abilities. It enables us to understand how the excess return was achieved, whether it was the result of good stock picking or whether it was merely due to positive sector allocation, being, for example, over-exposed to a sector which outperformed the market as a whole. If it was indeed the result of stock selection, the process allows us to analyze the drivers and assess whether it resulted from a large number of small "bets" or a small number of large "bets", an important distinction between potential luck and a repeatable edge.

The concentrated multi-manager approach

Our research has shown that most managers are not able to find value everywhere. This does not, however, mean that none can find value at all. Rather, they sometimes show a unique ability to pick stocks, but typically only within a particular area of the market, as shown in Figure 2. Once we have identified managers with a discernible acumen in picking stocks in a specific sector, we can combine them together to create a concentrated portfolio of active stock-pickers, each contributing their picks only in sectors where they've demonstrated consistent expertise. The resulting solution provides investors with the benefits of multi-management while addressing the key weaknesses outlined above. Figure 3, shown below, illustrates this new construct.

Figure 3. Illustration of JMCAM's concentrated multi-manager approach



Our research has led us to believe that active managers are hampered by portfolio management constraints and by a flawed distribution system which forces them to dilute their convictions. Our unique approach allows us to effectively identify and select superior stock pickers, and leverage their convictions within an identified sector of interest.

Each building block, by its nature, is highly concentrated, investing in a handful of holdings exposed to only one or two sectors of the market. When combined with other concentrated, sector-focused sleeves from managers with similarly demonstrated edges, adequate diversification is achieved. The resulting fund, at the aggregate level, is thus comprised of concentrated portfolios, which, when combined, creates a diversified portfolio of stocks.

A concentrated multi-manager approach, constructed in such a manner, provides a solution which maintains the benefits of multi-management, spreading contributions and risk, but without over-diversifying the aggregate portfolio or diluting the convictions of the underlying managers. This allows the solution to remain truly active and not fall into the pitfall of closet-indexing.

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About JMC Asset Management LLC

Founded in 2012, JMC Asset Management (JMCAM) is an SEC-registered investment advisor based in New York. JMCAM is an independently operated affiliate of the JMC Family Investment Office.

JMCAM provides innovative investment products and tailor-made solutions based on the selection and allocation of quality and experienced equity managers. JMCAM also offers advisory services to institutional clients, leveraging its capabilities in the analysis and selection of US-based money managers.

JMCAM's principals have over 10 years average of industry experience, with knowledge in all aspects of the business from analysis and due diligence to the creation and management of customized portfolios.

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