Feature

Manager diversification. To diversify or to integrate?

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The use of a range of fund managers with diverse skill sets has become so commonplace for defined benefit pension schemes over the past 20 years, that to suggest a single manager might now be preferable for some schemes needs some explanation.

So, here we set out the merits of a mature defined benefit pension scheme integrating their mandates with a single risk manager and contrast it with the traditional case for the benefits of manager diversification.

The case for manager diversification

Diversification is one of the most important concepts in investment theory and one that often has positive connotations associated with it. When it is applied to support the division of an investment strategy amongst multiple asset managers, the traditional arguments put forward include:

- **Access to a wider range of specialist expertise:** It can be difficult to find a manager that has the requisite expertise across all the asset classes used in an investment strategy.
- **Reduced exposure to a single manager's active views:** A mix of managers provides diversification of active positioning within asset classes. This can be important to reduce the risk of a single manager's active views or management style significantly impacting the success or otherwise of the overall investment strategy.
- **Less operational risk:** Diversification lessens the impact of any potential operational, legal or business mishaps occurring at a particular manager.

The case against manager diversification

Consolidating most or all of the assets with a single asset manager seemingly runs counter to the popular mantra, 'don't put all your eggs in one basket'. However, there are several reasons why a single manager can be advantageous for some pension schemes.

- Mature pension schemes focus on a few core asset classes: De-risking often involves reducing the number of asset classes used by a pension scheme, to focus on assets such as high-quality bonds to help manage risk and increase certainty of outcome. As a result, fewer managers are needed. For a mature, well-funded scheme, a single manager can design a credit portfolio to deliver sufficient cashflows versus liability projections and only take as much credit risk as necessary given the required returns.
- An investment solution that operates in an integrated way can bring efficiency gains not available from 'siloed' managers: An integrated set-up allows the investment manager to determine how LDI and fixed income assets could work together to secure the funding outcome required, deliver the returns required as well as ensure sufficient liquidity to meet liability payments on the journey to full funding. If along the way collateral top-ups are required, the integrated solution would enable the manager to determine the most efficient source of such funds without compromising on the funding outcome or adding to trustee governance burdens.
- Managing an integrated liability-driven investment (LDI) strategy can reduce the amount of collateral needed: For an LDI portfolio, a single manager is well placed to ensure the right balance between the liability hedge ratio and size of the collateral pool. A single collateral pool that can be accessed for all hedging purposes will also reduce the amount of collateral needed. It can also potentially reduce the risk of needing to sell other assets at inopportune times.
- Governance is simpler with fewer managers: Trustees' governance budgets are increasingly being stretched, so monitoring and meeting with a large roster of investment managers can detract from the time and effort spent on investment strategy.
- A single manager can benefit from economies of scale: Consolidating a mandate, such as an LDI strategy integrated with a cashflow-focused bond portfolio, with a single manager can potentially lower fees, as the larger asset base allows the manager to pass economies of scale back to the underlying investor.
- Where an investor uses several fund managers that adopt active strategies that seek to add value relative to a market benchmark, the tracking error (or risk) of that portfolio will typically fall as more managers are added to the roster. However, as maturing pension schemes increasingly allocate to contractual assets that deliver the required quantum of cashflows at the right time, there is increasing homogeneity of portfolios even if they are split across several managers. This higher correlation across portfolios reduces some of the risk reduction benefits that might have been previously available.

Continue manager diversity or benefit from integration as the endgame approaches?

There are compelling arguments for both manager diversification and a single-manager approach and we do not believe there is a single 'right' answer for all investors. Instead, we believe the story is more nuanced, with the relative attractiveness of each option largely governed by the unique circumstances that each investor finds themselves in, as shown in the table below.

How to decide whether diversification or integration is the way forward for your pension scheme

	Manager diversification preferred when...	Solution integration preferred when...
Nature of investment strategy	Large number of different/niche asset classes	Fewer asset classes/where core strategy is more 'risk management' focused
Reliance on alpha	High	Low
Correlation of managers' performance to one another	Low	High
Are different components of the investment strategy likely to interact with one another?	No	Yes
Is there a desire or need for collateral efficiency/synergies?	No	Yes
Nature of reporting and analytics valued by investor	Mandate-focused, with focus on performance versus market indices and benchmarks	Scheme-level outcome-focused, with focus on analytics versus the investor's overall objectives
Willingness to devote governance budget to manager monitoring	High	Low

Improvements in pension schemes' funding levels have facilitated greater de-risking as schemes rely more on contractual maturing returns instead of diversified market-based returns. Against this backdrop, the benefits of manager diversification start to diminish as pension schemes adjust their approach. In this environment, we believe there are significant benefits to increasing integration. This is especially true where an asset manager excels in the relevant components and is able to deliver trustees greater efficiency, transparency and certainty through such integration.