VAR CAPITAL

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Since we left the world of private banks to set up a multi-family office, clients expect us to analyse not just the investment portfolios managed by our firm, but also the portfolios that they have with other providers. This has resulted in us reviewing over 50 portfolios for trusts, corporates and family office clients. During the reviews there was a number of similar themes that we came across in various portfolios, which we detail below.

Multiple layers of fees

Many portfolios had a significant allocation to funds, adding layers of fees for clients. Whilst funds have a role to play in portfolios, a high allocation to mutual funds leads to higher expenses and potentially lower returns.

Questions to ask your investment manager:

1. What % of the portfolio consists of funds, fund of funds or hedge funds?
2. What % of the portfolio funds are manager's in-house funds?
3. What is the Total Expense Ratio ('TER') of your portfolio, including all the fund fees / costs, and (if relevant) what is the reason for the high % allocation to funds?

Case study: A trust client with a 10m GBP portfolio with a major private bank

- *2.5m GBP of the portfolio was invested in debt mutual funds, so the client was paying two layers of fees; the portfolio management fee and the fee of the underlying mutual fund*
- *A further 2.5m GBP was invested in equity funds, which as above, also had 2 layers of fees*
- *1m GBP was invested in the manager's own fund of funds, which essentially had 3 layers of fees: the portfolio management fee, the fund of fund fee and the underlying funds' fees*
- *Including both the portfolio management fee and the underlying fees of the funds, the TER of the portfolio was over 2%, which is high given the size of the portfolio*

Low yielding bonds

Many portfolios have significant allocations to bonds with minimal, or even negative returns. Whilst there may be a valid investment reason for such allocation, we found that often it was the result of a rigid and static asset allocation.

Questions to ask your investment manager:

1. What % of the portfolio is in government and investment grade bonds with low yield?
2. What is the yield of the bonds in the portfolio, broken down by bond type?

Case study: Family office client with a 25m EUR portfolio

- *9.1% was invested in short-dated UK gilts, yielding -0.1% after fees*
- *3.0% in ultra-short investment grade bonds, yielding 0.2% after all fees*
- *7.0% in UK gilts, returning 0.6% after all fees*

- *78% of the bond allocation was in inflation linked bonds, yielding -1.1% for German inflation linked bonds and 0.2% for US inflation linked bonds, after all fees*

Poor fund selection

Mutual funds can be a positive contributor to performance in a portfolio. In markets where you need local expertise, having a specialist fund manager can improve returns significantly. However, many investment managers have funds in the portfolio which are not offering strong risk adjusted returns and have not done so for some time.

Questions to ask your investment manager:

1. Can you give me a peer group rating of the funds in the portfolio, using a tool such as Morningstar?
2. Can you share how often you change funds in the portfolio and past examples where you have done so in my portfolio?

Case study: Charity client with a major Swiss private bank

- *The portfolio had a global bond fund that had a 1-year ranking of 3rd percentile, meaning that it had been outperformed by 97% of funds in its universe. Its 3-year performance ranking was 8th percentile and 5-year was 22nd percentile. Over a 3-year period, it had underperformed peers by 9% and was one of the worst performing funds globally.*
- *There was also an allocation to a high yield bond fund which had a 3-year ranking of 37thpercentile and had been underperforming for a few years*

High allocation to cash / cash like assets

Cash can be a strategic asset class. It can enable rapid deployment when a good investment opportunity arises. However, some investment managers can have too high an allocation to cash, which could act as a drag on performance. Furthermore, full portfolio management fees are charged on the cash portion of the portfolio.

Questions to ask your investment manager:

1. Why is there this allocation to cash or cash like investments in the portfolio?
2. What is the plan to deploy this cash in the next quarter?

Case study: Various clients

- *One investment manager allocated 31% of the portfolio to cash or cash like instruments*
- *In another portfolio, an average of 19% was invested in cash throughout the year*

Other issues to note or identify while reviewing a portfolio

- High exposure to non-base currency: many portfolios have a high exposure to currencies, other than the base currency of the client. Whilst currency exposure may be strategic, this may cause volatility in performance and such a high FX exposure may not be suitable for those clients who 'live and breathe' solely in their base currency.
- Static asset allocation: some investment managers do not make any significant changes to their portfolios, even when markets are volatile, or performance is poor
- Too much churn: on the other hand, some portfolios we looked at, had too much trading activity. Focus here should be on the manager's fee structure and whether there is a per trade fee which may incentivise overtrading.

Whilst there is no right or wrong portfolio management approach, we believe that the investment management industry can benefit from greater transparency, focus and interrogation on the themes detailed above. We hope that this article empowers trustees and client advisers to ask the right questions to their investment managers, leading to better managed portfolios and improved standards for the industry.

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