

The Fellowship of Wealth Management

Combining managed accounts and
balanced funds to drive better outcomes



“One ring to rule them all,
one ring to find them,
one ring to bring them all
and in the darkness bind them.”

Gandalf

The Fellowship of the Ring

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With the recent rise in the popularity of managed accounts, you would be forgiven for thinking that the diversified managed fund is a product of yesteryear.

We, however, believe there's a role for diversified managed funds when held alongside or within a managed account.

Contributors

Contributors



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Senior Investment Specialist

Chris is a seasoned investment specialist with over ten years of experience in financial services including previous roles at BT. Known for a strategic and analytical approach, he is responsible for managing our relationships with ratings houses and asset consultants, as well as keeping the market abreast of our portfolios. Chris holds a Bachelor of Commerce from Sydney University, majoring in Economics and Finance, and is a CFA Charterholder. When not immersed in market analysis, Chris enjoys being out on the water with a fishing rod in hand. He is passionate about financial education and regularly shares insights through editorial and media.



Tom Kim
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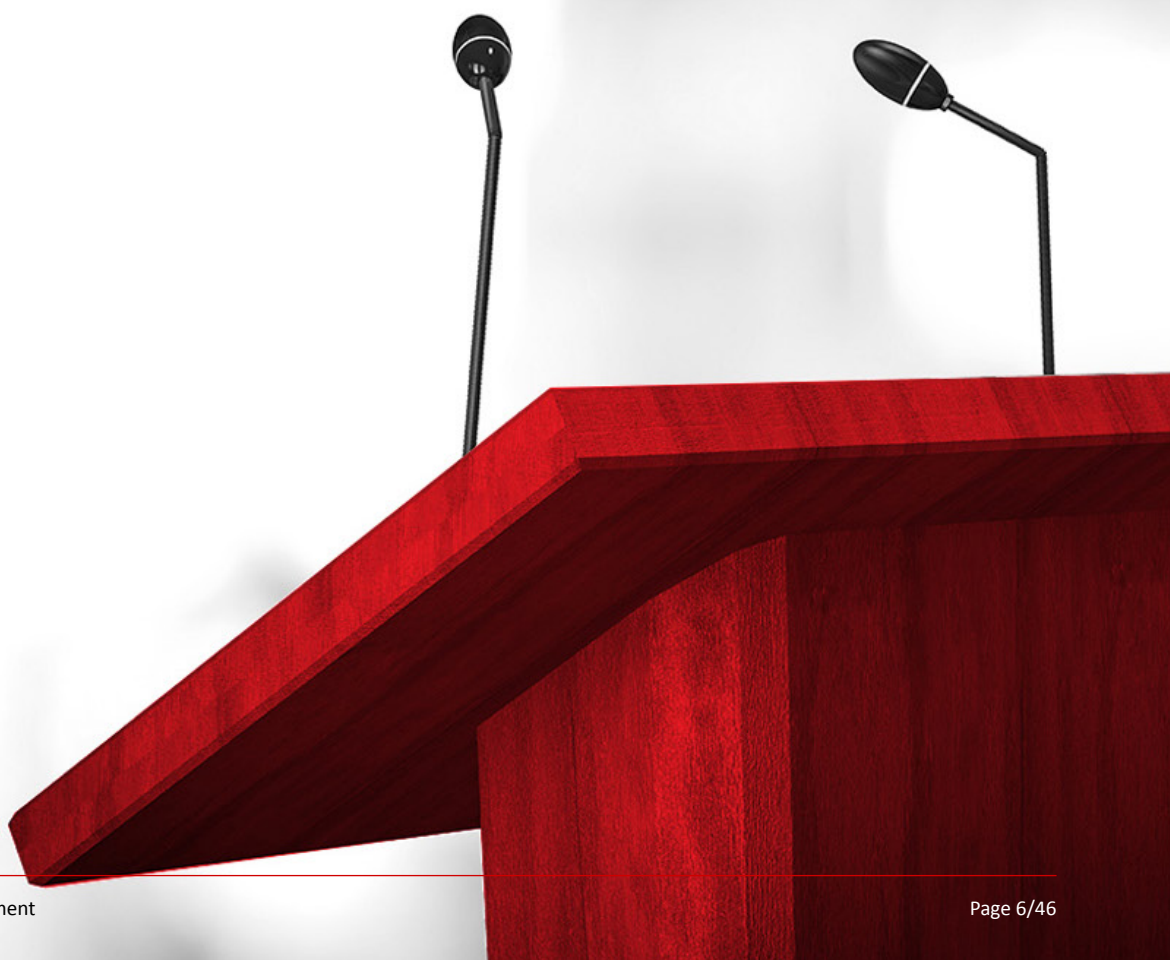
Tom Kim joined Allan Gray as an Investment Specialist in 2024. He previously held a similar role at Ophir Asset Management and product roles within the Pandal Group. Tom holds a Bachelor of Commerce (BCom) Accounting and Finance from the University of Technology Sydney and has completed Level 1 of the CFA Program. When not in Martin Place or helping our clients with his in depth knowledge of our contrarian investment philosophy, he enjoys a round of golf, watching basketball and hiking.



JD de Lange
Chief Operating Officer

JD de Lange joined Allan Gray Australia in 2010 as Head of Retail before moving to the Chief Operating role in 2015 where he now also oversees strategy, operations and servicing. Previously, JD spent nine years with Allan Gray in South Africa, the largest privately-owned South African investment company that was started by Orbis' and Allan Gray's founder, Allan W.B Gray. JD holds a B. Proc Degree (University of Pretoria).

Introduction



Faced with a need for greater efficiency due to increased regulatory burden, the number of Australian advisers using managed accounts has meteorically risen.

In just a decade, usage has grown from 17% to 56% of advisers, with another 22% describing themselves as ‘potential users’¹. They have provided a powerful tool, assisting many businesses by freeing up advisers’ time and combatting the compliance demands placed on the financial advice industry.

The adoption of diversified managed accounts reflects a seismic shift in the investment attitudes of market participants. Previously, most advisers deemed it too risky to entrust just one active investment manager with building a diversified portfolio for their clients. As a result, active, diversified managed funds have seen relatively limited use within the Australian investment landscape in recent years. However, the widespread adoption of managed account solutions has shown that attitudes are shifting.

It is imperative that the investment solutions clients are offered today will deliver the desired long-term investment outcomes. This can only be achieved by ensuring rigorous governance, compliance and investment scrutiny for all products.

It should be said that as a fund manager, we exist in this ecosystem and in many ways are benefitting from managed account adoption, where our highly rated single asset funds have seen use. We are, however, contrarian by nature, which causes us to question orthodoxy, and consensus, at any one time. Therefore, it should come as no surprise that we will question the sole use of managed accounts and put forward the relative advantages of an active diversified managed fund. We will also discuss the ways in which such an approach could be used within the current investment landscape.

To borrow from the excellent Lord of the Rings, we believe there shouldn't be “one account to rule them all”.

“You step into the road, and if you don't keep your feet, there is no knowing where you might be swept off to.”

**JRR Tolkien,
The Fellowship of the Ring.**

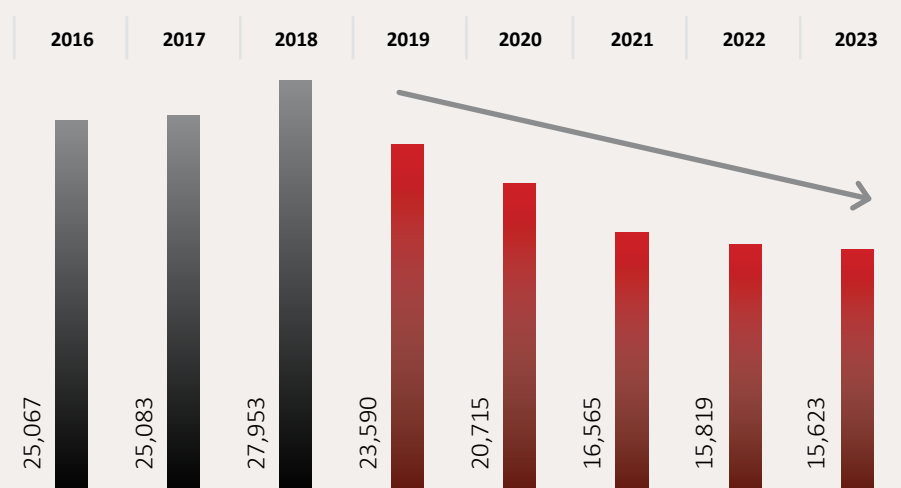
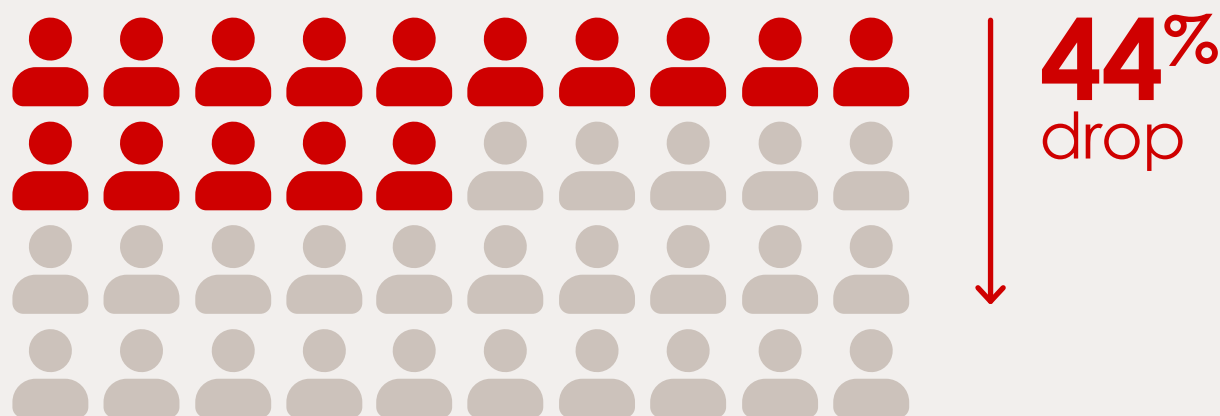
¹ Key Findings: SPDR ETFs / Investment Trends Managed Accounts Report (April 2023)

The changing advice landscape

- 1. Managed accounts – an administrative solution to growing compliance requirements
- 2. Managed funds – heading in the other direction
- 3. Differences between managed accounts and managed funds
- 4. Are they really so different?
- 5. Return of concentration risk

The compliance requirements placed upon Australian financial advisers has grown significantly in recent years, with more proposed regulatory change on the horizon. Readers will likely know these challenges all too well. Regulatory change following the Hayne Royal Commission has driven a significant drop in adviser numbers. The graph below shows, from an industry peak in adviser numbers in 2018, numbers have fallen 44%².

Financial adviser numbers in Australia have declined



Source: Adviser Ratings 2024 Australian Financial Advice Landscape Report, Allan Gray Australia.

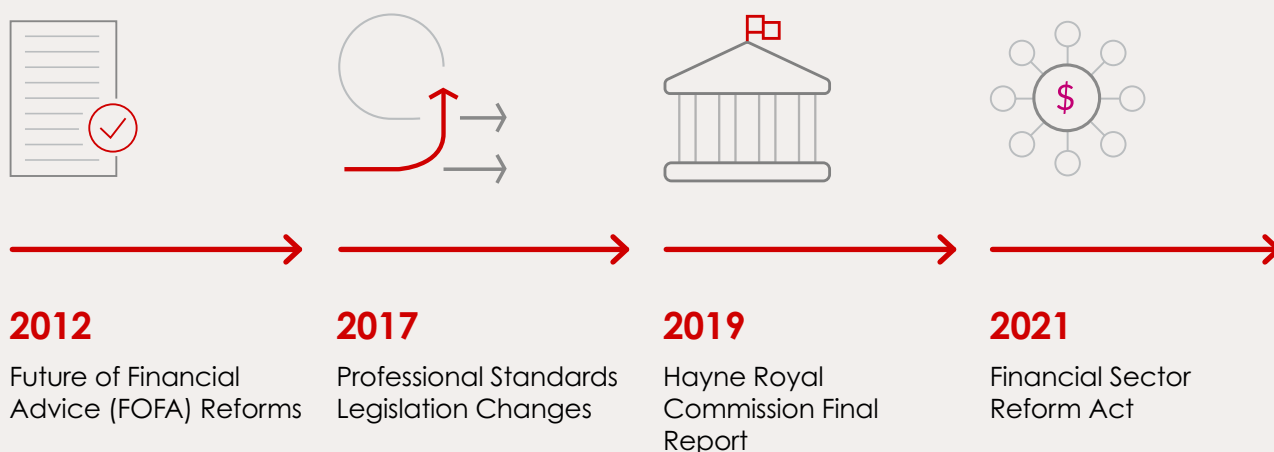
² Adviser Ratings 2024 Australian Financial Advice Landscape Report

Regulation has also caused an explosion in the cost of advice, with the median advice fee now sitting at \$3,960, a figure 58% higher than when the Royal Commission was held³.

Sadly, this has affected the ability of 'ordinary' Australians to benefit from professional financial advice. Three million Australians were helped by a planner in 2007 and, despite Australia's population growing over 25% during the period⁴, that number had fallen to just 1.8 million by 2022.⁵

These regulatory demands have also significantly increased the time to service each client, creating a big hurdle to running a successful and profitable advice practice. These tensions have caused advisers to look at ways they can save time and build efficiencies into their businesses.

| Significant changes in the advice industry



Source: Allan Gray Australia.

³ Adviser Ratings 2024 Australian Financial Advice Landscape Report

⁴ Australian Bureau of Statistics <https://www.abs.gov.au/statistics/people/population/population-clock-pyramid>

⁵ Vickovich, A., Financial Review, Why Australians can't afford financial advice (and how to fix it), <https://www.afr.com/policy/tax-and-super/why-australians-can-t-afford-financial-advice-and-how-to-fix-it-20230201-p5ch1o> (February 2023)

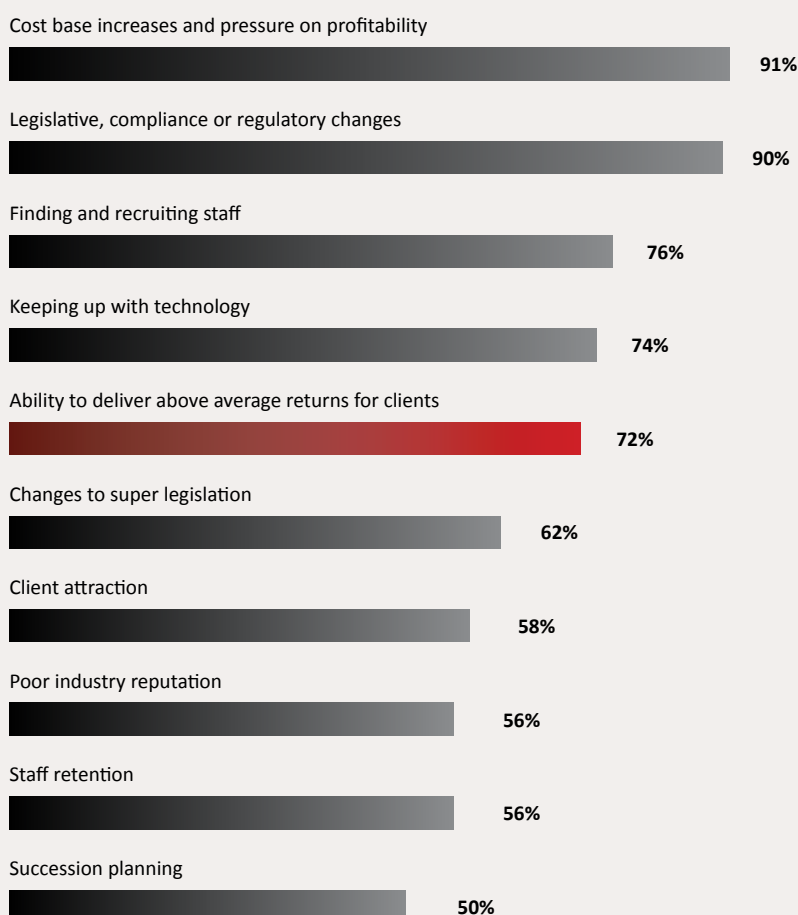
1. Managed accounts – an administrative solution to growing compliance requirements

Administration and compliance requirements continue to afflict advisers. Numerous surveys have shown this, and as an example BT recently conducted its Adviser Sentiment Index 2024 which asked, “Which of the following do you see as being a challenge for you and your practice in the next two years?”.

Over time, many advisers have performed the role of portfolio manager on behalf of clients. They would build model portfolios, often standardised at a few different levels of growth asset exposure (e.g. conservative, balanced, growth, high growth) using underlying securities, managed funds and exchange-traded funds (ETFs). These models would then form the basis for advice provided to new clients, and a model to which existing client portfolios could be rebalanced back to over time. Making changes to the model created friction and impacted the adviser’s time, as a Record of Advice (ROA), requiring agreement from the client, was needed to make any alterations. Rebalancing usually required some manual intervention.

Many advice practices still operate under this process and do an excellent job in assisting clients towards their investment goals. But to free up time, a lot of advisers have switched to using diversified, separately managed accounts, often with ‘off-the-shelf’ products that are available on platforms. Some advice practices and dealer groups with sufficient scale and a desire to retain some level of input into investment decisions have worked with a third-party to build their own set of ‘customised’ managed accounts, which they have then shifted most of their client base into. Managed accounts have provided an administrative solution, with the promise of greater efficiency and stronger client relationships.

Top ten challenges advisers face

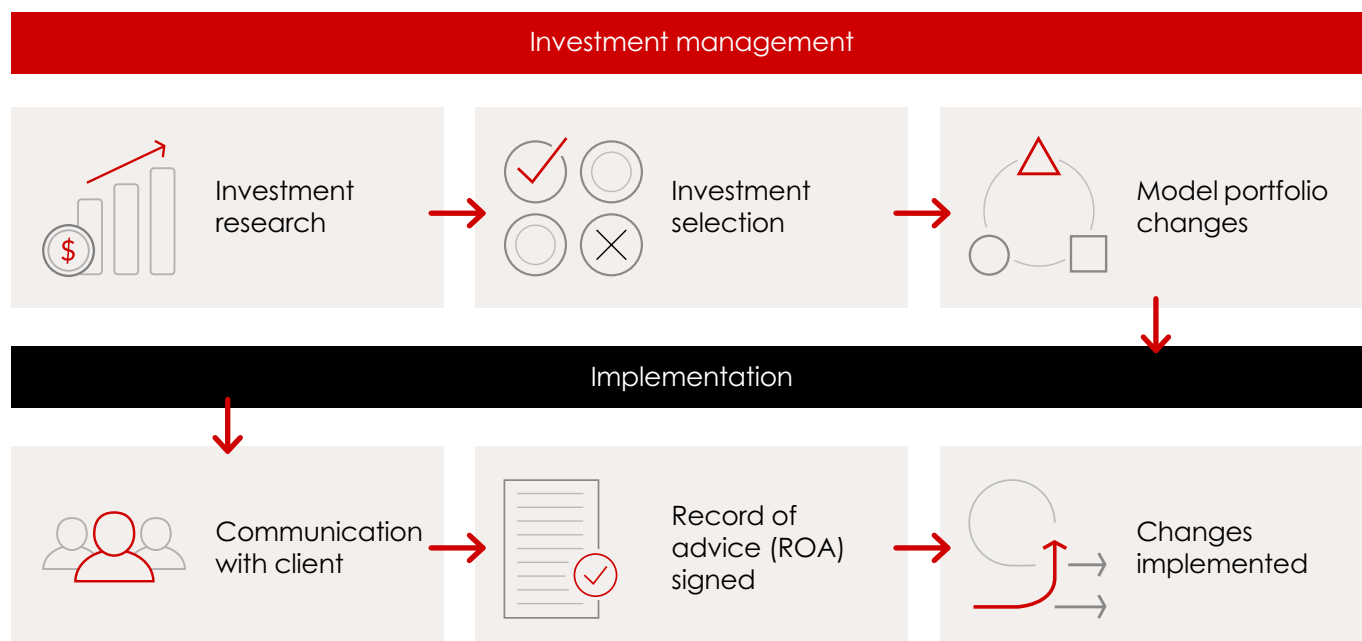


Source: BT, April 2024.

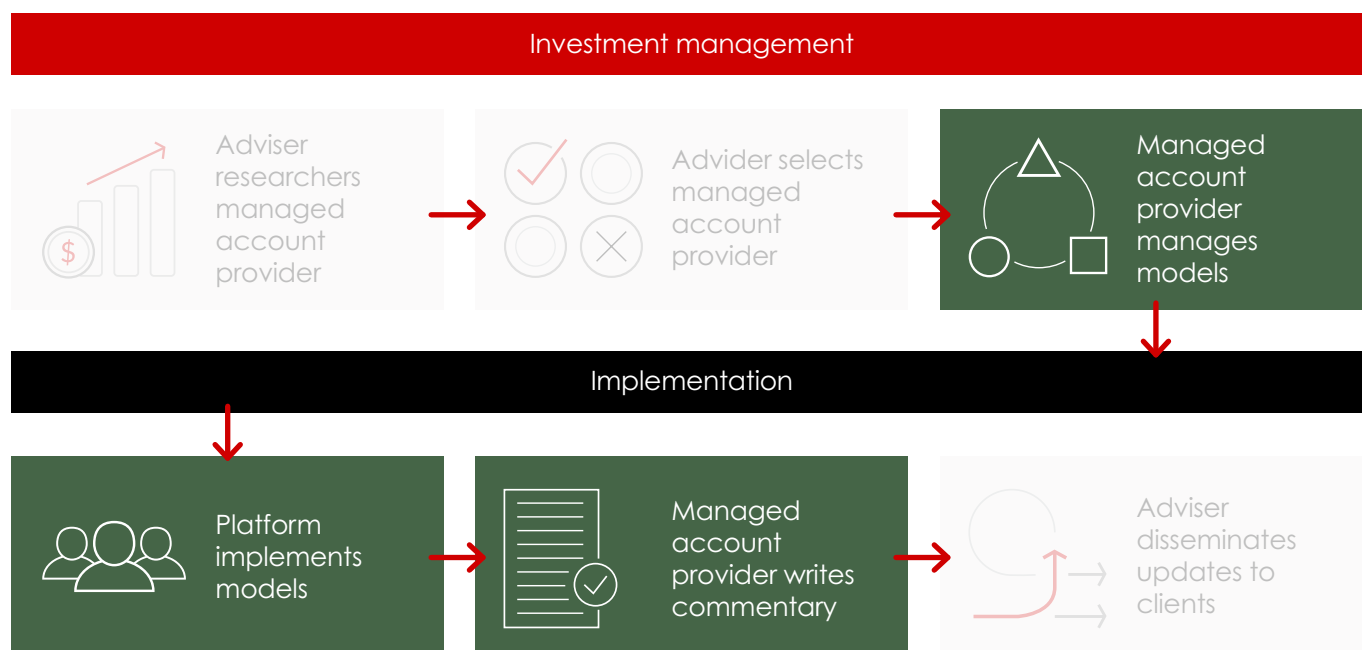
In the figure below, the green shading highlights work that has been effectively outsourced by advisers using off-the-shelf managed accounts.

Portfolio management has changed over time

Then (advisers managing and implementing model portfolios)



Now (using 'off-the-shelf' diversified managed accounts)

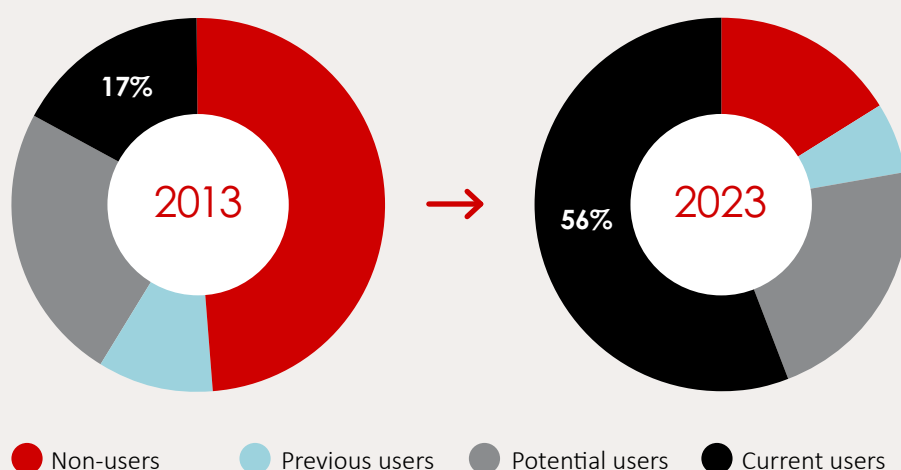


Source: Allan Gray Australia.

The SPDR ETFs/Investment Trends Managed Account report is undoubtedly the most robust and useful study reflecting adviser attitudes and use of managed accounts in Australia. It shows just how big the shift to managed accounts has been and confirms the driving forces behind their rapid adoption.

As the graph shows, in just a decade, usage has grown from 17% to 56% of advisers, with another 22% describing themselves as 'potential users'⁶. According to a census conducted by the Institute of Managed Account Professionals (IMAP) in conjunction with Milliman, managed account FUM at the end of December 2023 reached \$194.8bn, having increased by 20.47% in the prior six-month period⁷. \$108.8bn of this total was held in separately managed accounts.⁸

Managed account users are increasing



In just a decade, usage has grown from 17% to **56%** of advisers

Source: Key Findings: SPDR ETFs / Investment Trends Managed Accounts Report (April 2023), Allan Gray Australia.

62% of respondents have used managed accounts for less than three years⁹, reflecting how recent and rapid the adoption has been. Managed accounts' popularity can also be seen in the proliferation of the number of them available. There are approximately 1,100 off-the-shelf managed accounts now available in Australia, with two thirds being multi-manager or diversified models¹⁰.

⁶ Key Findings: SPDR ETFs / Investment Trends Managed Accounts Report (April 2023)

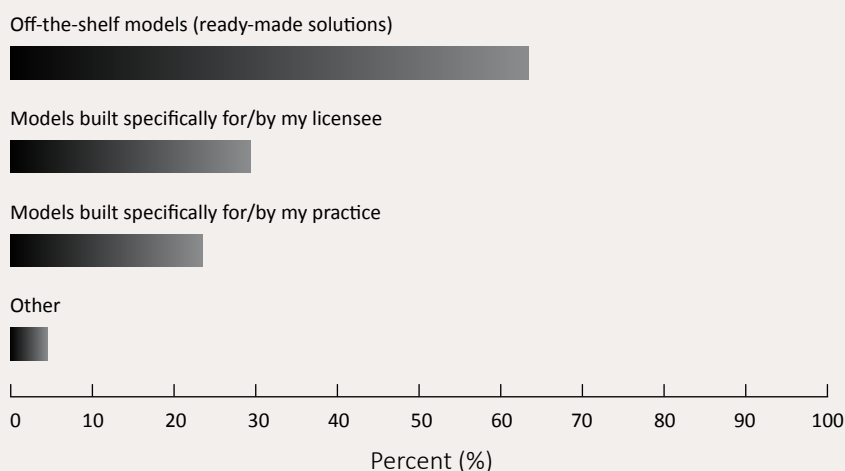
⁷ IMAP and Milliman Media Release (11 March 2024)

⁸ IMAP and Milliman Media Release (11 March 2024)

⁹ Key Findings: SPDR ETFs / Investment Trends Managed Accounts Report (April 2023)

¹⁰ Schaafer, S., The Next Iteration: Off the Shelf and Custom Managed Accounts, https://www.ssga.com/au/en_gb/intermediary/etfs/insights/the-next-iteration-off-the-shelf-and-custom-managed-accounts (26 July 2023)

Types of models recommended in the last 12 months (among managed account advisers who use SMAs on platform)



There are approximately 1,100 off the shelf managed accounts

Source: https://www.ssga.com/au/en_gb/intermediary/etfs/insights/the-next-iteration-off-the-shelf-and-custom-managed-accounts, April 2023.

The benefits of managed accounts that advisers cite as driving adoption are first and foremost: freeing up time to focus on other tasks, reducing operational risk for the business and lowering their compliance burden¹¹.

Benefits of recommending managed accounts

1

“Frees up my time to focus on other tasks”

2

“Reduces operational risk for business”

3

“Lower compliance burden”

Source: Key Findings: SPDR ETFs / Investment Trends Managed Accounts Report (April 2023).

For many advisers, managed accounts have led to significant time savings, allowing them to service more clients than might previously have been possible. According to the key findings of the SPDR ETFs / Investment Trends 2023 Managed Account Report, the average time saved by advisers who have made the switch adds up to over 17 hours per week¹².

¹¹ Key Findings: SPDR ETFs / Investment Trends Managed Accounts Report (April 2023)

¹² Key Findings: SPDR ETFs / Investment Trends Managed Accounts Report (April 2023)

2. Managed funds – heading in the other direction

Managed accounts are flourishing; they already dwarf diversified (multi-asset) managed funds in both number and assets. Diversified managed funds have not seen very widespread usage by Australian financial advisers.

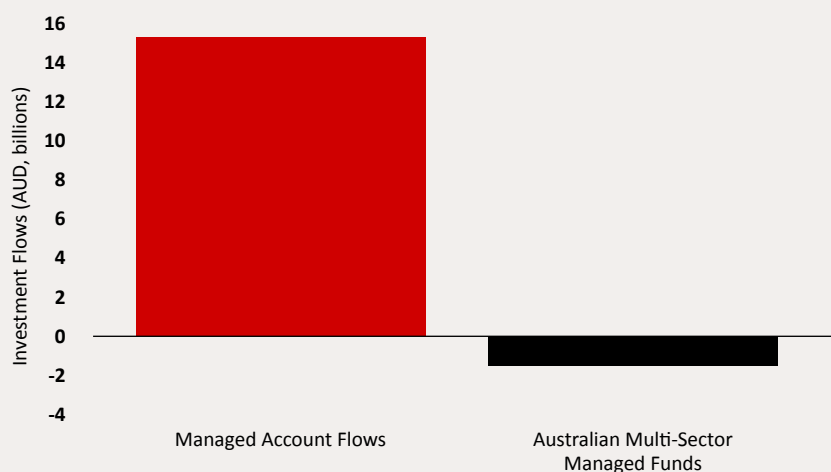
Morningstar Direct data shows that as at August 2024, only 14% of Australian managed fund FUM was held in multisector options¹³. Excluding Vanguard and MyNorth's passive options, which have seen significant success, the fraction falls further to less than 10%¹⁴.

While the number of managed accounts available has rapidly increased, there was only one new managed fund

launched in Morningstar's Multisector Growth Category in 2023¹⁵. Managed accounts are attracting the bulk of new industry flows, while diversified managed funds remain in outflow.

Up until the recent popularity of managed accounts, there seems to have been a relative dearth of advisers willing to utilise active, diversified approaches on behalf of clients in a very meaningful way.

Investment flows in second half of 2023



Source: Managed Account flow figure: IMAP Census of Managed Account FUM, 31 December 2023.
Australian Multi-Sector Managed Fund flow figure: Morningstar Direct, 31 December 2023.

¹³ Morningstar Direct, August 2024

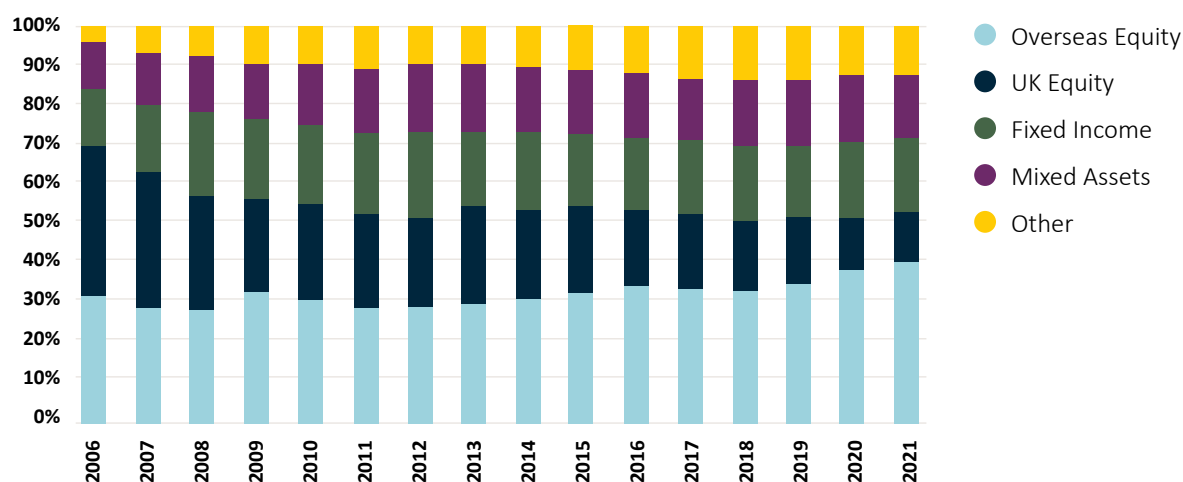
¹⁴ Morningstar Direct, August 2024

¹⁵ Morningstar Direct, August 2024

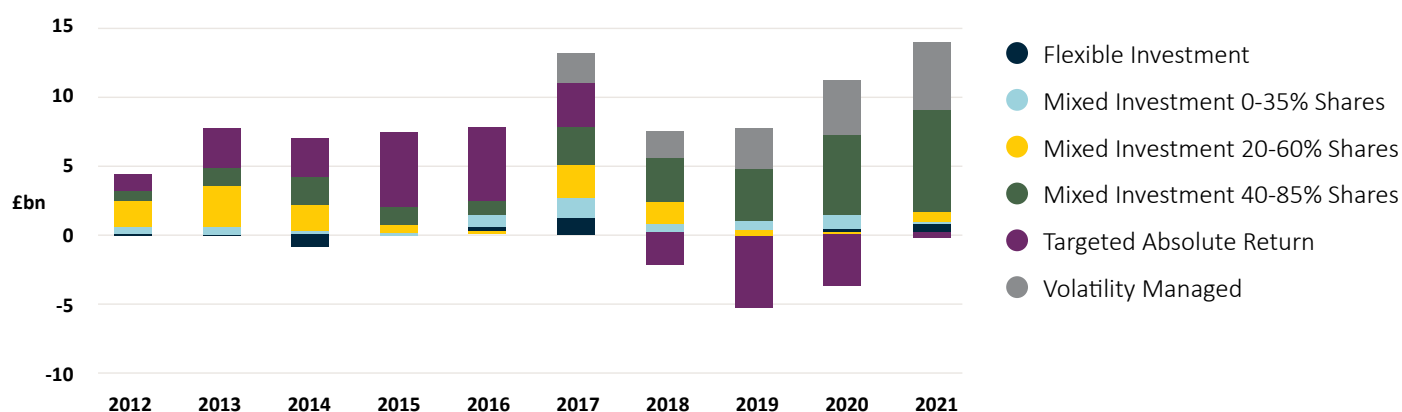
This differs greatly to what we've seen in the overseas markets in which we operate. In the UK retail market for example, mixed asset funds represent an increasing portion of the asset mix. According to the Investment Association's 'Investment Management in the UK' 2021-2022 Annual Survey, "Outcome and allocation funds have been consistently in favour over the past ten years... with a total net retail inflow of £71.1 billion across the decade"¹⁶. Mixed investments with a 40-85% allocation to growth assets have seen the bulk of the flows within this category in recent years.

Funds under management split by asset class

FUM by asset class (2006-2021)



Outcome and allocation, net retail sales by sector (2012-2021)



Source: The Investment Association, Investment Management in the UK 2021-2022 Annual Survey, September 2022.

¹⁶ The Investment Association, Investment Management in the UK 2021-2022 Annual Survey (September 2022)

3. Differences between managed accounts and managed funds

Key differences

	Managed accounts	Managed funds
Asset Ownership	Investors have beneficial ownership of assets underlying the managed account	Investors own units in the fund, rather than the fund's underlying assets
Transaction Transparency	Investors have complete transparency over transactions	Transaction disclosure is generally more limited
Accessibility	Must be accessed via an investment platform	Can be accessed via direct investment with the manager in addition to being accessed via platforms
Fee Consistency	The managed account portfolio management fee can differ depending on the investment platform selected, complicating comparisons	Each unit class will offer the same fee structure
Performance Comparability	Performance outcomes can differ across clients due to differences in trading and rebalancing procedures, and fees, across platforms	Each unit class will provide the same, published investment outcome for investors. Easier to independently assess past performance.
Investment Optionality	Generally more limited use of investment options such as derivatives	Managed funds can use a wider range of investment options such as derivatives to manage risk

Source: Allan Gray Australia.

One of the most attractive benefits of managed accounts, relative to managed funds, is the tax management possibilities resulting from individual ownership of the underlying assets. However, customisation and management of tax outcomes at the individual client level is in direct conflict with the reason most advisers are adopting the SMA structure – to free up more time. This may be why tax-effective/ CGT management and direct ownership of individual securities rank second to last and last in the list of advisers' preferred benefits¹⁷.

¹⁷ Key Findings: SPDR ETFs / Investment Trends Managed Accounts Report (April 2023)

4. Are they really so different?

Diversified managed funds (and diversified ETFs) arguably address the same primary concerns that have driven the adoption of managed accounts.

Shifting the asset selection and portfolio management to an external investment manager, they remove the need for the adviser to run model portfolios and implement these for each individual client. They free up the adviser's time, lower the compliance burden and reduce the operational risk for the advice business. The fund manager can rapidly change the securities or asset mix, without the need of agreement or an ROA from the end client. Supporting materials are readily available for clients, with high quality monthly fact sheets and quarterly investment reports almost always available.

Managed accounts that are built from an underlying set of managed funds or ETFs rather than individual securities are not necessarily more transparent than the selection of a single diversified managed fund or ETF – it all comes

down to what that selected fund manager is willing to disclose. The managed funds and ETFs that constitute a managed account are shown as a line item and directly owned by the end client. As an example, if the Australian equity managers within a managed account only disclose their top five stock holdings, but a diversified managed fund provides all holdings above 1% of net asset value, the diversified managed fund may in fact offer much greater holdings transparency to the end client.

The portfolio manager, whether they are structuring the product as a managed account or a managed fund, is ultimately trying to deliver the same thing for the end client – strong, risk-adjusted performance outcomes that will give the end client the best chance of achieving their financial goals and dreams.

5. Return of concentration risk

Just as they have shied away from entrusting one active investment manager with building a diversified portfolio for clients, Australian advisers have historically also avoided having one active manager in underlying asset classes.

It is extremely rare for an adviser to use a single, active investment manager for either their Australian or Global equity exposures. Advisers have deemed it inappropriate to give such a large responsibility to any active manager, even those 'core'-style portfolios exhibiting low tracking error. It is far more common to see a range of growth, core, value and potentially small-cap managers sharing responsibility for each of these sleeves, or simply a passive index manager providing very broad exposure.

The advent of managed accounts seems to have helped advisers overcome this psychological barrier. A number of prominent 'off-the-shelf' diversified managed account providers use direct shareholdings within their Australian equity sleeves. A very small amount do the same with international equities. The number of shares populating these portfolios is often much lower than the average active equity manager. The attractiveness of managed accounts as an administrative solution seems to have helped advisers reach a state of comfort in having one active manager responsible for entire asset classes, and all portfolio management responsibility for most of their client base.

We are not arguing against having a fairly concentrated portfolio within an asset class. What we are highlighting, and what the rapid adoption of managed accounts shows, is a newfound willingness to outsource both security selection and asset allocation to one external manager. This represents a seismic shift in mentality, and approach.

"That still only counts as one"

Gimli

The Return of the King



The relative advantages of active, diversified managed funds



- 1. The ability to take a truly bottom-up approach
- 2. The opportunity to protect clients through market hedging at the portfolio level
- 3. Using currency management to control risk
- 4. Broad researcher oversight
- 5. Performance comparability

As an investment manager offering only managed funds, it has been interesting to watch the rapid adoption of managed accounts. As mentioned, we exist in this ecosystem, and in many ways have benefitted.

Having highly rated single-asset funds that are looked upon favourably by the third-party investment managers that are constructing these managed accounts has in many instances led to adviser usage, where there may not have been previously. The nature of managed accounts, where a single investment decision can be implemented quickly and reflected across all client portfolios, rather than slowly being rolled out as each end investor is contacted and signs an ROA, also means that portfolio inclusions lead to more rapid inflows.

We also don't doubt that for advisers who were previously performing the role of portfolio manager, it has led to greater efficiency, assisted them with the compliance burden and helped to foster a goals-based approach to the advice relationship.

But we are also contrarian by nature and, as such, naturally question the

consensus, and those things that are most popular. It has been puzzling to see such a rush to implement managed accounts when the primary concerns driving their adoption could also be addressed by entrusting an active fund manager with multi-asset portfolio management responsibilities.

Managed funds offer several comparative advantages that we believe make them worthy of consideration. These include:

- the ability to take a truly bottom-up, security-by-security approach to portfolio construction
- tools to manage downside risk through hedging markets and managing currencies, as they can use a wider range of investment options such as derivatives
- a number of informational advantages that assist advisers in performing due diligence.

1. The ability to take a truly bottom-up approach

There are two main approaches to constructing diversified portfolios: top-down, and bottom-up.

Bottom-up managers focus on fundamentals, analysing individual companies' expected earnings and cash flows to value equities and bonds, while top-down investing takes a broader perspective, emphasising the analysis of macroeconomic factors, industry trends and market conditions to make investment decisions.

Of course, there isn't a black and white line between top-down and bottom-up investing, with most top-down managers considering fundamental valuations, and bottom-up investors considering how their portfolios may perform given differing future macroeconomic environments. But the approaches are very different in their starting points and primary considerations, and resulting portfolios often look starkly different.

To the best of the author's knowledge, there is not a single managed account in Australia that holds all equity and fixed income exposure at the individual security level. Most diversified managed accounts are entirely comprised of underlying ETFs and managed funds, with no direct holdings at all. Some have an underlying managed account allowing for direct holdings of preferred Australian equities, a select few also hold international equity exposure directly, but even these have the management of all other asset classes effectively outsourced to other fund managers or index providers.

It has to be this way, due to the nature of the businesses launching managed accounts. Customised managed accounts are typically constructed by an investment committee comprised of the senior advisers in an advice practice and a third-party, who are offering their services to multiple businesses, building many different portfolios.

Many 'off-the-shelf' managed accounts have been launched by ratings houses that leverage their existing product research work. Passive managers are essentially combining underlying ETFs and managed funds they already offer into different risk profiles (eg balanced, growth, high growth) to launch their own managed accounts. None are actively selecting individual securities across all asset classes, they are using existing building blocks and overlaying their portfolio management expertise.

A single individual may have the capacity to perform the role of portfolio manager and build client portfolios using underlying managed funds and ETFs. Advisers have been doing so for decades. But building diversified portfolios from underlying direct securities requires multiple, full-time analysts covering each asset class, as well as portfolio management expertise to appropriately cover the investment universe.

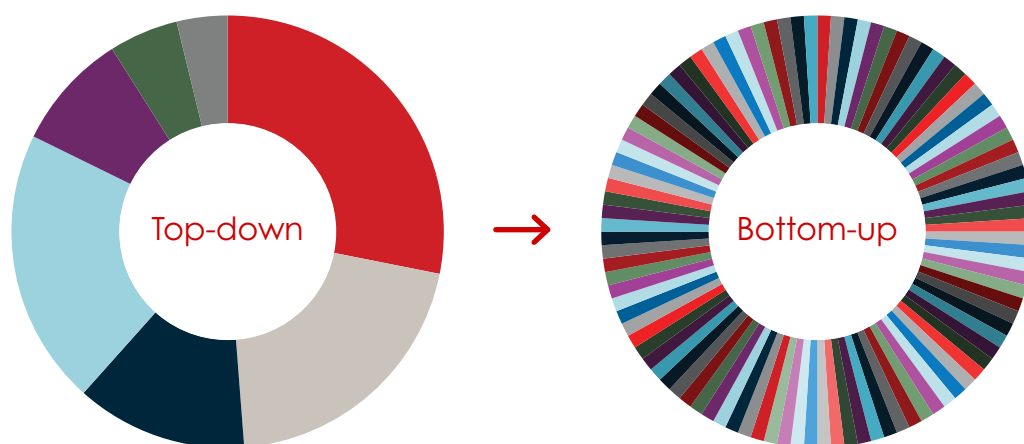
The managed fund structure allows one to build an entire multi-asset portfolio on a security-by-security basis, which offers a number of advantages over the typical building block approach using underlying ETFs and managed funds. For one, the client only pays one layer of investment management fees. This is different to a managed account portfolio built with underlying building blocks, with each having their own fees in addition to a portfolio level fee.

It also allows for a single manager to undertake complementary fundamental research of both the equity and bond offerings from a company. This allows one look at the entire capital structure of a business and decide where it is most attractive to have exposure

– debt or equity. When executed in a disciplined and consistent manner, this investment approach offers the potential for superior returns and reduced risk of loss. Capital is best allocated at the security level because information quality is much higher there, than at an asset class or index level.

A security-by-security approach leads to asset class weightings that are an organic outcome of the constant competition for capital between all of the individual opportunities across the investment universe. Managers should also analyse overall risk factor exposures to ensure they have not inadvertently become too exposed to any particular risk.

Bottom-up, instead of top-down



- Australian share managers
- International share managers
- International share managers (hedged)
- Global fixed interest managers
- Australian fixed interest managers
- International small companies managers
- Emerging markets managers

- ✓ Direct equity exposure
- ✓ Direct fixed income exposure
- ✓ Commodity exposure
- ✓ Cash

Source: Allan Gray Australia.

2. The opportunity to protect clients through market hedging at the portfolio level

Managed accounts in Australia are platform-based investment vehicles. Platform providers are essentially given a model portfolio by the model manager and create an investment product based on the underlying assets and weightings provided.

This means that any limitations of the individual platforms on which a managed account is made available will directly impact the investment flexibility of the managed account. If a model manager's preferred managed fund or ETF is not available on a particular platform and the platform is unwilling or unable to have it added, the asset needs to be substituted for another option. Given the breadth of most investment menus, this is not commonly a major issue, but there are areas where the platform-based nature of managed accounts poses limitations.

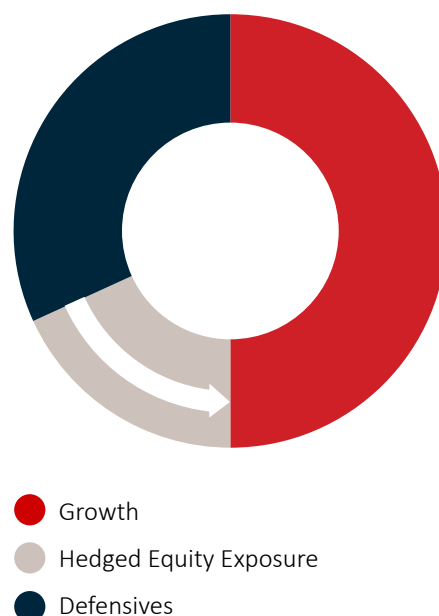
To the best of the author's knowledge, none of the major platforms currently hosting managed account solutions in Australia allow for the direct trading of derivatives including futures, forwards or options. This poses a limitation on investment options. Managed funds on the other hand, can use a range of derivatives to adjust risk exposure at the portfolio level, including futures, forwards and options.

We provide an example here demonstrating how derivatives may be used to manage risk. Let's say you have found some fundamentally attractive companies listed in a particular region, but you do not want to take on too much market risk. By 'going long', or buying, the equity positions in these companies but shorting the overall index, you can maintain exposure to the individual opportunities but mitigate the risk of a broad decline in the overall market.

A 'long-only' approach to portfolio construction, without the benefit of derivatives, might instead have to rotate out of those equity positions into defensive assets in order to best manage identified risks. And what happens if bonds look particularly unattractive, as was the case in 2020, when investors were largely being offered return-free risk? A unit trust structure with the ability to use futures and options can create an absolute-return-style exposure within their fund with hedged equity exposure, essentially removing the beta exposure but retaining the potential for alpha. The managed account provider without these tools available to them may be forced into less attractive portfolio positioning.

Of course, managed account providers can include underlying managed funds that can utilise these tools. But that is a different proposition to using these tools themselves to manage risk at the portfolio level. The author is aware of two innovative managed account providers who have overcome these limitations by including derivative exposures in a unit trust structure, which is then used within their managed account offerings to manage risk and capture some of these benefits mentioned above.

Derivatives can be used to hedge market risk



Source: Allan Gray Australia.

3. Using currency management to control risk

A lack of derivative trading options on Australian investment platforms also impacts the ability of managed account providers to manage currency exposures directly. This affects the manager's ability to protect investors from the downside risk of overvalued currencies in a highly targeted way.

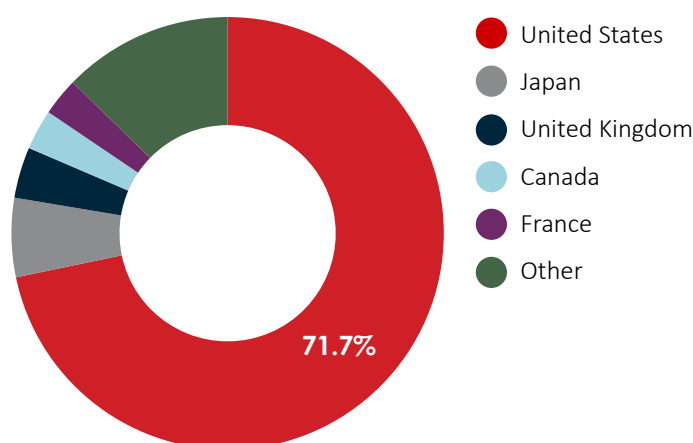
Again, an example will help. Let's say a portfolio manager deems the US dollar as overvalued relative to the Australian dollar but believes other foreign currencies represent an attractive preserve of value. Under a managed account structure, to reduce US dollar exposure the portfolio manager may feel compelled to switch out of an unhedged managed fund or ETF into a currency-hedged option. In doing so, they have also reduced exposure to all other foreign currencies. Without the ability to use derivatives, the blunt tools available can limit decision making.

A unit trust structure with these tools available could instead use forwards to reduce exposure to the US dollar, without reducing exposure to other foreign currencies. In doing so, they

can protect the downside risk of currencies they deem to be overvalued but maintain currency diversification across other foreign currencies. Alternatively, US currency exposure could be maintained, while the portfolio manager seeks to reduce exposure to other foreign currencies they deem to be overvalued and therefore poor preserves of value.

Actively managing currencies to preserve value and purchasing power may be more important than ever, given how concentrated global markets have become. The US market now comprises more than 70% of the MSCI World Index at the end of July. As a result, portfolios today have likely become less diversified across currencies than they have been historically.

| Currency exposure can be managed in a very targeted way



Source: MSCI World Index Country Weights as at 31 July 2024.

4. Broad researcher oversight

Many guardrails exist to protect financial advisers and end clients when investing in investment products. One of these is the work performed by the major research houses in our domestic market.

Their work involves assessing and evaluating the performance, risk, and other characteristics of various investment products. These ratings are designed to help investors make more informed decisions about where to invest. The research houses perform both qualitative and quantitative analysis under robust frameworks.

Often, the research process concentrates on what has been called the ‘four Ps of manager selection’. Research houses are looking for the following:

- Managers need a clearly articulated philosophy, and to demonstrate they’ve acted in accordance with their own beliefs.
- They need to have a consistent and disciplined process for selecting securities, managing risk and achieving portfolio outcomes.
- They assess the organisation’s people, and require that they be appropriately resourced, with analysts and portfolio managers having the necessary experience and expertise.
- While past performance is not necessarily indicative of future results, researchers do want to see that over the long term, fund managers have added value after fees charged, over and above lower cost alternatives. They want to see evidence of the manager’s skill and consistency.

The researchers are provided with immense transparency from investment managers under non-disclosure agreements, with the amount of data required to be collected and analysed often necessitating a full-time employee on the side of the asset manager, dedicated to meeting the requests for information received. Following data analysis, meetings are held between the researchers and key investment personnel, so the investment managers can be further interrogated.

The outcome of the process is a rating applied to the investment product. These ratings are usually an important gatekeeper to advisers selecting an investment product; many dealer-groups require a minimum rating from one or more research houses for their advisers to implement a product.

There is a long list of diversified managed funds and ETFs that have gone through this process with one or more ratings houses, received an outcome and continued to be monitored. However, most off-the-shelf and customised managed accounts have not been rated yet and therefore have not been subject to this level of scrutiny. The ability of the research houses to analyse managed accounts is complicated by the fact that most houses have their own offerings in this space – conflicts will need to be carefully managed.

5. Performance comparability

The structure and implementation of managed accounts makes it complicated for advisers and clients to compare performance. For a client researching the historical after-fee performance outcomes of off-the-shelf and customised managed accounts, it is a much more difficult process than it is for managed funds.

Managed funds have one set of net-of-fee performance numbers, irrespective of whether they are accessed directly, or via different platforms. This will generally be publicly available at the investment manager's website, public websites like Morningstar and Money Management, and paid data systems, like Morningstar Direct, Lonsec's iRate or Zenith's Mosaic. An investment manager that doesn't make their past performance figures readily available raises big question marks in the minds of prospective investors.

It is a very different situation when it comes to managed accounts. The complication comes from the fact that managed accounts are essentially model portfolios implemented via platforms, with the platforms performing the necessary trading and rebalancing. The performance of the same managed account can vary across platform providers, due to differences in implementation, and portfolio management fees across differing platforms. Differing portfolio sizes for clients can also lead to different performance outcomes.

As Annika Bradley writes in the Journal for Managed Account Professionals, "The challenge with fees and costs in the managed account space is that the Australian Securities and Investments Commission's (ASIC's) Regulatory Guide 97: Disclosing fees and costs in PDSs and periodic statements (RG97), stopped short of prescriptive fee and cost disclosures for platforms, let alone managed accounts, making comparisons tricky"¹⁸.

The only publicly available, net of fee, display of managed account performance the author is currently aware of is on the Netwealth website. There, they provide a helpful tool allowing the comparison of managed models publicly available on the Netwealth investment menu.

We believe our investment industry would greatly benefit from a consistent methodology of performance disclosure by managed account providers, to assist advisers in comparing investment options.

¹⁸ Bradley, A., Making comparisons across managed accounts – Why regulatory guidance is required, The Journal for Managed Account Professionals (December 2023)

Designing a multi-asset portfolio to maximise client outcomes

- › 1. Flexibility to drive returns
- › 2. A bottom-up portfolio of individual securities
- › 3. Managing portfolio risk using derivatives
- › 4. Active currency management
- › 5. Aligning our interests with investors' interests



Having considered the differences between two investment structures, we can consider what the ideal diversified portfolio should look like.

We believe it should be structured as a managed fund due to the advantages outlined in this paper, and would:

- Allow the portfolio manager considerable flexibility, both within and across assets classes
- Be built on a security-by-security basis, from the bottom up
- Use derivatives to manage risk at a portfolio level
- Actively manage currencies, to reduce potential losses from currencies believed to be overvalued
- Align the portfolio manager's interests with the end clients' interests.

This is what we have sought to deliver clients with the Allan Gray Australia Balanced Fund, launched in 2017.

“The Fund uses the same philosophy that the wider Allan Gray and Orbis Group has used for over 50 years.”

1. Flexibility to drive returns

An important concept in portfolio management is ‘breadth’, which relates to the number of independent, active investment decisions that are undertaken over a period.

Developed by Richard Grinold and Ronald Kahn, the Fundamental Law of Active Management suggests that outperformance requires a combination of both skill and the opportunity to express one’s skill (breadth)¹⁹.

If you believe an active manager has the skill to outperform, you should allow the manager considerable flexibility and opportunities to make active investment decisions where they find the most attractive opportunities. In practice, however, diversified portfolios can be quite limited in terms of the flexibility given to managers to make decisions. For one, the tactical asset allocation ranges, allowing deviation from the baseline allocations to asset classes (strategic asset allocation), can be very tight, only allowing very constrained rotation between assets. Managers may also be limited in the

types of assets they are allowed to allocate capital to or restricted in terms of geographic allocations.

We have sought to allow considerable flexibility in the design of the Allan Gray Australia Balanced Fund. That allows us to allocate capital where we are finding the most attractive, contrarian opportunities. While our custom benchmark allocation consists of 60% equities, 40% fixed income and cash, equity exposure can range from as low as 40% up to 90%, and we can hold hedged equity exposure when we deem it appropriate to a limit of 10% of NAV. Fixed income and cash can range from 10% to 50% and the Fund can hold commodity-linked instruments, up to a maximum 10% exposure. Asset allocation ranges are reflected in the table below.

Allan Gray Australia Balanced Fund target asset allocation ranges

Asset type	Range (%)	Benchmark (%)	
		International	Australia
Equity	40-90	24	36
Fixed Income and Cash	10-50	16	24
Commodity-Linked Investments	Up to 10	0	0

The portfolio may from time to time move outside these ranges in pursuit of the Fund’s investment objectives.

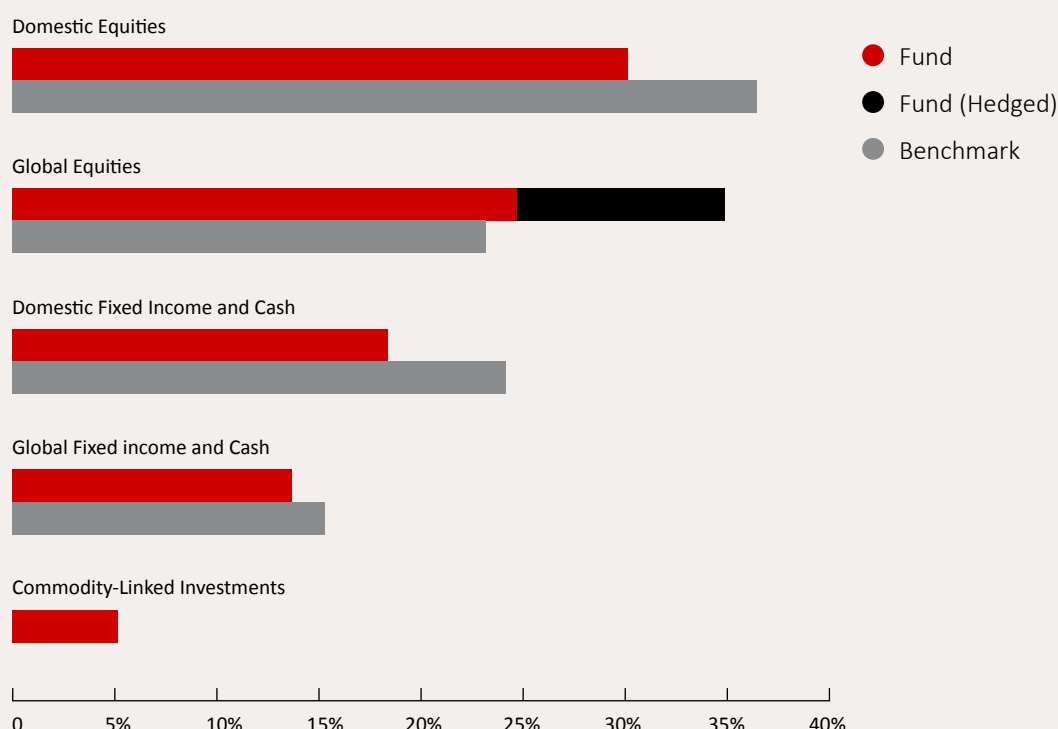
Source: Allan Gray Australia. The Benchmark is a custom benchmark which comprises the S&P/ASX 300 Accumulation Index (36%), S&P/ASX Australian Government Bond Index (24%), MSCI World Index (net dividends reinvested) expressed in AUD (24%) and JP Morgan Global Government Bond Index expressed in AUD (16%).

¹⁹ Grinold, R., and Khan, R., Active Portfolio Management: A Quantitative Approach for Producing Superior Returns and Controlling Risk (October 1999)

This flexibility has allowed us to take advantage of the relative value on offer across asset classes since the Fund was launched. Allocation to defensive assets was high prior to the COVID-19 sell-off, given the stretched equity valuations on offer. This sell-off allowed us to increase exposure to both domestic and global equities at far more attractive prices. In 2023, despite a composite benchmark with a higher allocation to Australian equities, we were overweight global shares as our bottom-up research found more opportunities in overseas markets. The positioning proved beneficial, as global shares substantially outperformed the Australian market during the year.

As at 30 June 2024, the Fund looks very different to its benchmark and the typical diversified portfolio. With equity markets nearing all-time highs, we are underweight equities on a net basis after accounting for 9% of the gross global share exposure being reduced through the use of exchange-traded derivatives, which allows for some protection in those periods where market indices fall. We also have 5% exposure to commodity-linked instruments (ETF linked to gold), and in the global fixed interest space, we currently favour Treasury-Inflation-Protected Securities (TIPs) over 'standard' government and corporate bonds.

Asset allocation for the Allan Gray Australia Balanced Fund



Source: Allan Gray Australia, 30 June 2024. The custom benchmark comprises the S&P/ASX 300 Accumulation Index (36%), S&P/ASX Australian Government Bond Index (24%), MSCI World Index (net dividends reinvested) expressed in AUD (24%) and JP Morgan Global Government Bond Index expressed in AUD (16%). Domestic Equity includes Newmont and Virgin Money CDIs and New Zealand companies listed on the ASX.

2. A bottom-up portfolio of individual securities

The Allan Gray Australia Balanced Fund is built from direct security holdings, an important distinction from diversified portfolios that use a building block approach with underlying managed funds and ETFs.

Most diversified portfolios will have outsourced equity and bond research to completely different companies. Even if they are comprised of different investment funds offered by one investment manager, it is likely that equity and bond teams are working separately and comprised of different people. This can make it difficult to assess the relative attractiveness of different asset classes or funds when deciding portfolio weightings. In the case of a fund manager combining existing funds, tension can be created when changing allocations, as to do so, the fund manager must take money away from one part of the business and give it to another. Internal political considerations could cause friction in movement of capital.

Building a portfolio from the bottom up, using individual securities, seems to us a much better way to manage a multi-asset fund. It enables one to analyse the entire capital structure of a business and decide which securities might be most attractive, whether that is equities, bonds or hybrid offerings. It also means every security is constantly fighting all

others for capital, and every security is bought with the expectation it will be an active contributor to fund returns. It does, however, require considerable resourcing and expertise to take such an approach.

Our Balanced Fund is built by Simon Mawhinney, Chief Investment Officer and Managing Director of Allan Gray Australia, and Alec Cutler, who has overall responsibility for multi-asset strategies at our sister company, Orbis Investment Management Limited. Simon's domestic team is comprised of nine analysts, while Alec's multi-asset team is comprised of eight individuals and manages the global segment of the Fund.

This Fund structure allows Australian equity investments to be assessed against global counterparts at an individual company level. As an example, recently Simon and Alec have jointly compared Australian gold mining corporations against international counterparts and made investments based on relative, fundamental valuations.

3. Managing portfolio risk using derivatives

Derivatives are often considered risky, but they can also be used to manage risks at a portfolio level, without having to always buy and sell underlying portfolio holdings to adjust exposures.

We frequently employ broad equity market hedging by using futures to manage exposures to different markets within the Allan Gray Australia Balanced Fund. It allows us to take positions in attractive shares, without dialling up exposure to overall market risk, if we don't wish to do so. Hedging is a tool that can be employed to manage portfolio risk.

US ten-year government bond yield



Source: Federal Reserve Bank of St. Louis, July 2024.

An example may help. The graph above shows the US ten-year government bond yield had been falling for decades and got to extremely low levels around 2020. Many nations were offering negative interest rates. At that time, we saw many of the government and corporate bonds that were available as offering substantial risk, with low reward.

Many diversified portfolio managers, without the ability to use derivatives and with limited flexibility in adjusting portfolio positions, had large exposures to long-duration bonds at this time, despite their relative unattractiveness. This proved detrimental to clients when yields eventually rose from their historic lows.

The Balanced Fund was positioned very differently. It was significantly underweight bonds and those bonds that were held were much shorter duration than the index and therefore less impacted by rising rates. As an

alternative, we were able to take exposures in attractively priced equities but use hedging to reduce overall market exposure and not take on too much market risk. Such hedging softened the impact of the panic that gripped markets during the COVID-19-related sell-off in early 2020.

As at 30 June 2024, we held short futures positions in a number of equity indices, including the S&P 500, Nasdaq and Euro Stoxx 50, allowing us to control overall exposure to equities without having to reduce positions in attractive individual companies in these regions.

“We were able to take exposures in attractively priced equities but use hedging to reduce overall market exposure and not take on too much market risk.”

4. Active currency management

Within the Allan Gray Australia Balanced Fund, currency allocations are actively managed through the use of derivate overlays. This is a tool that can be used to help manage risks within the Fund.

Asset allocation for the Allan Gray Australia Balanced Fund

Asset allocation (%)

	Australia	North America	Europe and UK	Asia	Other	Total
Equity	24	5	12	11	2	55
Hedged Equity	0	7	2	0	0	9
Fixed Income and Cash	18	10	2	0	0	31
Commodity-Linked Investments						5
Total	42	22	16	12	2	100

Currency allocation (%)

	Fund	Benchmark
Australian dollar	63	61
Japanese yen	10	4
British pound	7	2
Norwegian krone	4	0
Euro	4	6
US dollar	1	25
Other	11	2
Total	100	100

Note - Totals presented in this table may not sum due to rounding.

Source: Allan Gray Australia, 30 June 2024.

Divorcing equity research from currency research enables us to seek out attractive investment opportunities in countries where we believe the currency is overvalued. We believe this is the case with the United States as at 30 June 2024. We have 12% equity exposure in the region, having found a number of attractive opportunities including companies, such as Kinder Morgan, which specialises in owning and controlling gas pipelines and terminals. However, we only have 1% exposure to the US dollar after accounting for currency forwards.

Instead, our research suggests that the Japanese yen, British pound and Norwegian krone are undervalued and we have taken the opportunity to overweight these currencies.

Most multi-asset portfolios have to manage currencies in a very different way. Often, they can only do so from switching between hedged and unhedged managed funds and ETFs. This can become difficult if there isn't a hedged version of their preferred managed fund or ETF. Even when available, it means a much less targeted and flexible approach to managing currency risk.

“What about side by side with a friend?”

Legolas Greenleaf
The Return of the King



5. Aligning our interests with investors' interests

When the interests of investors and investment managers are aligned, it creates a shared objective of maximising returns.

The temptation in managing multi-asset portfolios is to deliver index-like returns, as it is unlikely that a client would ever fire a manager for minor underperformance. Career risk rises when portfolios look substantially different from an index, as a different return profile inevitably means there will be periods of relative underperformance, during which clients may question the manager's skill.

As a diversified portfolio gathers assets, the temptation grows to deliver index-like returns and not stray far from the crowd (i.e. reduce tracking error). Reducing tracking error can lower the risk of outflows, while the investment manager can continue to take active management fees from an already substantial asset base.

This is a raw deal for investors; there is absolutely no reason for them to pay active management fees for index-like returns when inexpensive, passively managed diversified portfolios are readily available.

To ensure that managers continually strive to outperform and deliver alpha for clients, we believe the right incentive structures need to be in place. As Charlie Munger once said, "show me the incentive and I will show you the outcome".

We have sought to align our interests with clients through employee ownership of the firm, co-investment in our Funds and through performance fees.

The latter of these three is almost non-existent in the diversified portfolio space. This is because diversified funds using a building block approach may have underlying managed funds that might also take performance fees under certain conditions. It is understandably seen as unacceptable by most investors for managers to 'double dip' and take performance fees at the portfolio level in addition to underlying assets.

The Allan Gray Australia Balanced Fund is different. With our individual securities, no investment fees are charged for underlying equity and bond holdings. The only exception to this is the 5% allocation to gold via the SPDR® Gold Trust ETF as at 30 June 2024. This allows us to have a performance fee at the overall diversified fund level, incentivising the fund managers to seek outperformance. Such a structure is a rarity in the multi-asset space.

Importantly, the performance fee is subject to a non-resettable high-water mark, meaning that any underperformance must be fully regained before performance fees can begin to accrue from subsequent outperformance. We believe this is the fairest way to structure such a fee and ensure that we are hand-in-hand with our investors and rewarded for outperformance.

Incorporating a diversified managed fund within the current investment landscape

- 1. Using multiple, multi-asset options to diversify decision makers
- 2. Adding exposure to a diversified portfolio of contrarian ideas may improve overall portfolio performance

1. Using multiple, multi-asset options to diversify decision makers

Despite a willingness to implement diversified managed accounts, it seems unlikely that advisers will suddenly start to use active, diversified managed funds for the entirety of client portfolios.

But using one managed account for all of one's customer base means putting immense responsibility in the hands of solely one investment committee. The counterargument to this point is that it isn't one external party – the building block approach means that you are considerably diversified across underlying managers and exposures. That may be true, but ultimately it is the portfolio manager's decisions around asset allocation, and their selections and trading of underlying building blocks, that will determine how the client fares. And so, if that's true, should we only have one decision-maker with one world view, or approach, determining those allocations? How could an adviser who wishes to diversify those responsible for their portfolio management, or benefit from some of the outlined advantages of diversified managed funds, do this?

Diversified portfolio solutions do not need to be mutually exclusive. Whether they be a diversified SMA, diversified managed fund or a diversified ETF, advisers can combine multiple multi-asset options. In doing so, they allow each diversified portfolio manager considerable flexibility to invest in the assets that they believe offer the best risk and reward at any one time. At the same time, they also diversify the business away from expressing the views of just one firm, or investment committee, in client portfolios.

Many advisers that use off-the-shelf managed accounts as a core component for client portfolios already add satellite exposures to bring in differing views and approaches by various investors. The same can be done with different multi-asset options. It's even easier

with a customised managed account – a different multi-asset option can be given a fixed allocation to bring in a different approach.

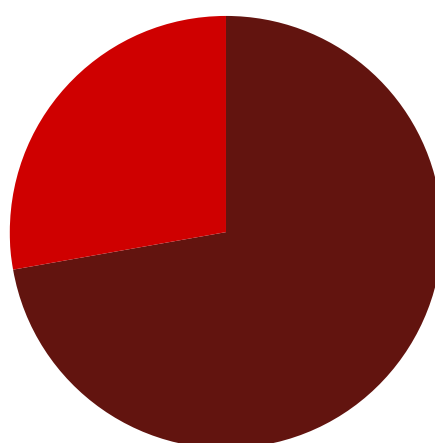
For example, combining top-down and bottom-up viewpoints and approaches could bring balance to an overall portfolio by mitigating the risk of macro calls gone wrong, or a market that takes a very long time to reflect fundamental value.

We sympathise with advisers that diversifying approaches to portfolio construction means adding some additional complexity into portfolios. But we believe the benefits of doing so more than outweigh the additional complexity.

"This day does not belong to one man but to all. Let us together rebuild this world"

**Aragon,
The Return of the King.**

How advisers can combine different viewpoints and approaches using multi-asset portfolios



- Bottom-Up Managed Fund
- Top-Down Managed Account

Source: Allan Gray Australia.

2. Adding exposure to a diversified portfolio of contrarian ideas may improve overall portfolio performance

Why would an adviser, seeking to reduce complexity and administrative work, add a second multi-asset portfolio manager into the mix?

We can look at the Allan Gray Australia Balanced Fund and the impact it would have had on overall investment outcomes if held alongside other multi-asset portfolios historically.

The Fund was launched in 2017 and has performed strongly against both managed fund peers and managed accounts.

Allan Gray Australia Balanced Fund performance relative to Morningstar sector

	7 Yr Total Return Rank	5 Yr Total Return Rank	3 Yr Total Return Rank	1 Yr Total Return Rank
Allan Gray Australia Balanced Fund	1/84	1/101	1/107	9/118

Source: Morningstar and Allan Gray Australia, 31 July 2024. Rank given within Morningstar's "Multisector Balanced" category. Morningstar's calculation of total return is determined by taking the change in price, reinvesting, if applicable, all income and capital-gains distributions during that month, and dividing by the starting price. The total returns do account for management, administrative, 12b-1 fees and other costs taken out of assets. Past performance is not indicative of future performance. Data can be sourced from Morningstar Direct. Funds within the Morningstar Multisector Balanced Category may not be available to all investors.

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Allan Gray Australia Balanced Fund performance relative to Netwealth sector

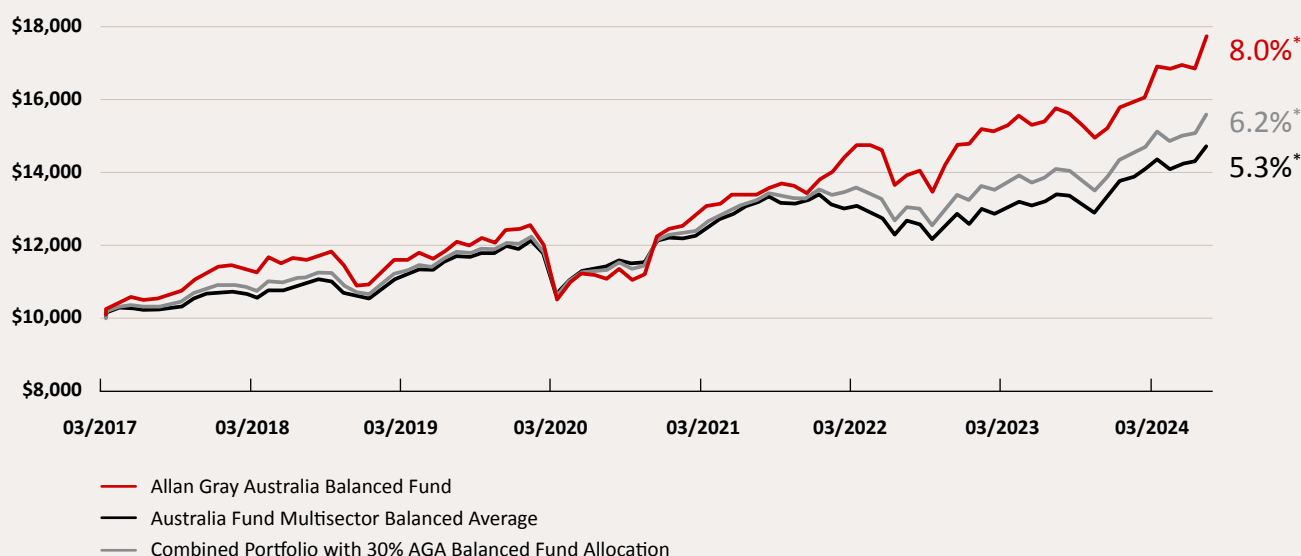
	5 Yr Total Return Rank	3 Yr Total Return Rank	1 Yr Total Return Rank
Allan Gray Australia Balanced Fund	1/14	1/23	16/33

Source: Netwealth and Allan Gray Australia, 30 June 2024 (latest available at time of publication). Rank given within Netwealth's Multi-Sector 40-60% and Multi-Sector 60-80% categories, available on their Super Accelerator Plus and Wealth Accelerator Plus menus. Data taken from <https://www.netwealth.com.au/nw/fund/CompareFundsAndModels/ManagedModels>.

Managed Model data has been prepared by Netwealth. Investment performance is simulated based on an investment made in the model at inception of the model. The investment performance shown in this table is unlikely to exactly match your actual investment returns. This is because the investments you hold in your managed account do not always exactly match those of your chosen models (for example, due to your personal investment preferences or the amount invested in the model). Managed Model returns are net of fees and transaction costs. For Managed Models, "cost" is the estimated % amount of management fees and costs, performance fees and transaction costs. Please refer to the Managed Model Menu for further information about the fees and costs.

The performance of the Allan Gray Australia Balanced Fund relative to the category average in which Morningstar has placed the fund (Australia Fund Multisector Balanced) can be seen in the graph below, along with the performance that would have resulted from a 30% allocation to the Allan Gray Australia Balanced Fund.

The result of a combined portfolio



Source: Morningstar and Allan Gray Australia, 31 July 2024. *Figures refer to annualised, net of fee returns since inception. Combined portfolio reflects a portfolio comprised of 30% Allan Gray Australia Balanced Fund, 70% Morningstar Australia Fund Multisector Average.

Since inception in 2017, the Allan Gray Australia Balanced Fund has delivered an 8.0% net of fee return, against a category average of 5.3%.

As a result, an allocation to the fund, held alongside the average competitor, would have improved returns over that period.

Impact on performance through allocation to the Allan Gray Australia Balanced Fund since March 2017

30% Allocation to AGA Balanced Fund	6.2%
15% Allocation to AGA Balanced Fund	5.7%
0% Allocation to AGA Balanced Fund	5.3%

Source: Morningstar and Allan Gray Australia, 31 July 2024. Figures refer to annualised, net of fee returns since inception. Remaining exposure reflects Morningstar Australia Fund Multisector Average.

Diversified managed accounts have seen rapid uptake within the Australian advice landscape, with their adoption primarily driven by advisers seeking to free up their time, reduce operational risk and lower their compliance burden²⁰.

At the same time, diversified managed funds have floundered, with almost no new offerings coming to market and existing products experiencing outflows. This is despite several relative advantages that the managed fund structure offers multi-asset portfolio managers and end clients, relative to managed accounts.

In adopting managed accounts as a whole-of-portfolio solution for their client base, advisers have shown a newfound willingness to place enormous responsibility in one business, or investment committee.

We believe that using multiple, multi-asset options is a viable alternative for advisers looking to diversify decision makers and bring in differing views. While this may add some complexity at a time when many are looking to simplify, we believe that striving for business efficiency must be balanced against seeking the best long-term outcomes for clients.

“We believe that using multiple, multi-asset options is a viable alternative for advisers looking to diversify decision makers and bring in differing views.”

²⁰ Key Findings: SPDR ETFs / Investment Trends Managed Accounts Report (April 2023)



“All’s well that
ends better”

JRR Tolkien
The Lord of the Rings

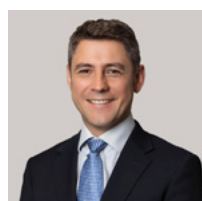
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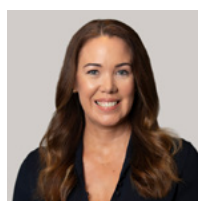
Contact us to discover how our investment approach could make all the difference to your client portfolios.

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