



## Guide To...

### Blending Managed Funds

Which investment manager is the best? Should you place your money with last year's winner in the hope of a repeat performance? Managers, like asset classes, have good years and bad. Even with a good long-term choice, you could suffer short-term setbacks if all (or a lot of) your money is with one manager and that manager, for whatever reason, has a difficult year. Blending investment managers can be a powerful means of potentially generating stronger returns while lowering investment risk.

#### ***What is Blending?***

Blending is a technique that seeks to balance risk against return. It is a method of combining different managed funds with diverse investment philosophies (ie. value, growth, or core) that perform differently across a variety of economic and other investment conditions.

Blending fund manager styles helps to prevent extreme swings in investment performance, thereby providing greater consistency of returns over both the short and long-term. The diversification benefits to the investor are improved markedly by adopting this approach.

With a blended approach, returns are not dependent on one particular manager's philosophy or style, which may or may not be suited to certain investment conditions. Instead, a range of investment styles is included. Within a blended approach, it is important to understand that, at any given time, some of the managers are likely to be performing well relative to their benchmark, while other managers are likely to not be performing well relative to their benchmark.

#### ***Investment Philosophies***

Broadly speaking, active managers can be broken into three particular philosophies – value, growth and core. Active managers believe that markets are inefficient and hence there is potential to “beat” the market and earn excess returns by actively selecting and trading shares. Since all active managers attempt to exploit the perceived market inefficiencies in different ways, value managers will not necessarily hold the same stocks in their portfolio as other value managers.

Similarly, growth and core managers will not necessarily hold the same stocks in their portfolios as other growth or core managers.

#### **Value Investing**

Value managers typically seek to purchase shares of companies that they believe are trading below their “true value”. The difference between “true value” and the current share price can be the result of several factors, including the company being out of favour with the current market trends, or the market not fully recognising the potential of the company. Since value companies are underpriced by the market, they tend to have lower Price-to-Earnings (P/E) ratios, lower Price-to-Book values, lower Price-to-Net Tangible Asset Backing (the break up value) and/or higher dividend yields. Value managers buy these “undervalued” stocks anticipating that once the market eventually realises their misjudgement, the stock price will be re-rated by the market and rise to its more fundamental value.

Value managers will still assess the growth potential and barriers to entry a company may experience. Thus companies held in value funds can also exhibit growth in earnings. However, the valuation factors dominate the investment screening and ranking process, hence value managers may not buy a stock they believe is expensive or trading at a premium relative to their valuation of the stock. This contrasts to growth managers who may be willing to pay a premium for the longer-term earnings potential of a stock.

As value managers seek these “undervalued” companies, they usually deliver better relative performance during times of declining or difficult investment conditions. This superior downside performance does not imply that a value manager should not produce negative returns, as the equity market that they invest into will still influence the manager’s performance. Value managers would generally be expected to underperform in the broader equity market, and possibly growth philosophy managers, during periods of strong market growth as investors seek out stocks that may have better profit potential in the future.

## **Growth Investing**

Growth managers typically seek to invest in stocks that exhibit strong growth tendencies. These include strong growth in profits, growth in earnings, growth in sales, growth in returns on capital etc. The managers will often focus upon the industry and barriers to entry of new entrants, the pricing power of the company and other factors that give the company a competitive advantage to sustain increasing profit margins. As these stocks offer a greater potential to generate profits in the future than the broader sharemarket, these companies can often be more expensive (usually a higher Price-to-Earnings ratio, P/E) relative to other stocks in the share market. Growth companies can be either established or emerging companies, but in all cases the company will show strong growth potential. Growth managers buy these stocks anticipating that the company’s earnings will continue to grow, resulting in a rise in the share price.

Growth managers will still assess the valuation of these growth companies in their portfolio construction process. Thus they do pay attention to the price they pay for the stock. However, growth factors will dominate the investment screening and ranking process, hence growth managers may be willing to pay a premium for the longer-term earnings potential of a stock. This contrasts to value managers who generally focus on buying “undervalued” stocks.

Growth managers are usually rewarded during periods of time when the economic landscape is positive and investors are looking forward to a company’s future prospects, but can experience underperformance relative to the market during times of market uncertainty and narrowed investment outlook. Also, companies misstating expectations in earnings forecasts can have their “growth premium” sold out of the share price very quickly.

## **Core Managers (Style Neutral/“GARP” (Growth At A Reasonable Price)/Rotational /Thematic)**

There is a distinction between “pure” style neutral managers who actively seek to avoid any style bias in their portfolios and managers who are more style indifferent. Style indifferent managers may have a style neutral tendency; however their investment process often leads to a portfolio with a slight bias towards value or growth. It is often these biases which lead to confusion with respect to the use of such terms as “style neutral”, “GARP”, “rotational” and “thematic”.

## **Style Neutral Investing**

Style Neutral managers typically seek to invest in stocks that will maintain the style unbiasedness of their portfolio. That is, they seek to avoid the strong biases that can be exhibited by value and growth managers, aiming instead to add value irrespective of which philosophy of investment is in favour.

ThreeSixty Research consider style neutral funds to exhibit no bias to growth or value over the full investment cycle or, depending on the manager, at a point in time (ie style neutral managers actively try to neutralise any bias towards growth or value).

## **GARP (Growth At A Reasonable Price) Investing**

GARP managers typically seek to invest in stocks that will grow at above average rates and are also attractively priced. That is, it is a style that combines the attractive characteristics of their traditional value and growth counterparts. GARP managers look for a stock with growth potential, but pay close attention to the price they pay (unlike growth managers who are willing to pay a premium for the longer-term earnings potential). Given this more conservative approach to growth investing, GARP managers tend to achieve less volatile results than either growth or value managers. However, this also means that they may miss out on the superior performance that value and growth managers may enjoy when their particular style is in favour.

## **Rotational Investing**

Rotational managers typically choose to ignore the investment ideology of growth and value managers. Instead they focus on deep fundamental analysis of individual companies to come to conclusions about their individual merit, regardless of whether the stock is value or growth.

Since rotational managers are focused on the fundamental merit of individual stocks, irrespective of their value or growth characteristics, there may be times where their portfolio exhibits a bias towards value or growth stocks depending on the market and their convictions. Rotational managers do not seek to neutralise any style biases in their portfolio, unlike true style neutral managers.

## **Thematic Investing**

Thematic managers typically aim to search out trends in the global macro economy that will result in certain companies or sectors achieving superior returns. They generally use macro economic research to identify factors, or themes, which will have a strong influence on company profitability and returns. The companies they select will have strong exposure to this economy wide factor or theme and hence be strongly influenced by it.

## ***Characteristics Within Investment Philosophies***

Within these broad active investment philosophies (value, growth and core), managers exhibit other characteristics, which together with their philosophy make up the managers' style of investment. These different characteristics can further improve the diversification of a client's portfolio when blending different managers and funds.

Such portfolio characteristics include:

- Size biased managers;
- Low turnover managers;
- Concentrated portfolio managers;
- High conviction managers;
- Benchmark unaware managers; and
- Alternative strategy managers.

## ***Why is Blending Important?***

So why don't we simply pick the best style at a point in time and switch between fund manager styles when appropriate? It is difficult, if not impossible, to pick the best investment style at a point in time and switch between fund manager styles when appropriate. While we have the ability to select above average funds over the long term, there may still be short-term downside risks. A blended approach seeks consistency of good performance rather than experiencing a spectacular year, which could then be followed by a very poor year and vice versa.

*If you have any queries in relation to the content of this material, please do not hesitate to contact Kate Kimmorley the Principal Financial Adviser at Kimmorley Financial Management on (07) 5591 1725.*

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