

STRENGTHENING THE FOUNDATION OF YOUR INVESTMENTS

Leveraging a Manager of Managers Approach

— David Kahn, Managing Director



What's inside our toolbox?

Implementation tools have proliferated to the point that investors can find a fund, separate account, or exchange traded fund (ETF) to access virtually any investment opportunity, regardless of how obscure it may be. This vast universe of investments presents many possibilities, but many potential complications as well.

At Convergent, we use an “open architecture” model, meaning we have the freedom to access essentially *any* investment vehicle across the world for our clients. Below, we will delve into the details of how we select what we believe to be the optimal investment vehicles from the thousands available.

Portfolio Building Blocks

The initial phase of our process involves defining each vehicle across two dimensions:



Scope

Is the fund specific or broad across asset classes?



Benchmark Correlation

How closely does the fund mirror its benchmark?

We prefer asset class specific vehicles over multi-asset class, flexible strategies. The reason is straight forward—we want to control the asset mix of each client portfolio because that is the ultimate driver of both return and risk. Our team of research professionals has the skills and tools to craft what we believe to be the ideal asset allocation for each client. We want the investment tools we choose to have predictable characteristics that are consistent with our current investment outlook.

We analyze each asset class and assess the following factors:



What is the likelihood that active managers can outperform passive, index-oriented vehicles?



What is the likelihood that Convergent can identify outperformers before they emerge?

If the answer to one or both of these questions is limited or negative, we utilize passively-oriented investment tools. For example, a passively-oriented strategy is typically applied with the bulk of our allocation to U.S. equities. Here, we believe a very mature and developed market for security analysis makes the opportunity for outperformance by active managers highly challenging. In less mature areas, our research suggests that markets are less efficient and we seek to identify active managers capable of generating outperformance beyond the relevant index over time.

Beware the Closet-Index Manager (and “hidden” fees)



The vast majority of portfolio strategies fall in the middle ground. In order to retain assets (and protect one’s livelihood), many fund managers broadly diversify across both stocks and sectors. This approach often results in performance that roughly tracks the fund’s primary benchmark. As long as performance is generally in line with the benchmark, the thinking goes, the fund can retain and continue to attract new assets (the term “closet indexer” is sometimes applied to this approach).

What is wrong with this approach? Nothing really, except for those nasty things called fees and taxes. If a portfolio correlates highly with its benchmark, but charges higher fees and generates more drag from trading costs and taxes, the likelihood of after-fee, after-tax (what we call “net, net”) outperformance becomes very low.

The Convergent Portfolio Approach—The Barbell



We deploy a “barbell” approach designed to capture the best of both active and passive strategies. When we believe the likelihood of “net, net outperformance” over a market index is low, we use passively-oriented strategies. With the opportunity to harvest tax losses on an ongoing basis, we believe these passive strategies have a high probability of outperforming on a net, net basis over time. Additionally, we utilize our firm’s size and scale to negotiate lower fees for our clients, so in certain circumstances, the incremental cost above ETFs or index mutual funds is nominal.

In markets where we believe net, net outperformance is achievable, we use active managers that tend to be fairly highly concentrated. With these managers, the bulk of fund capital is focused on their best investment ideas. We believe if we are going to invest our client's money with active managers, we only want firms that possess the power of conviction. After all, who wants a fund manager's 178th best stock idea in their portfolio? However, with concentrated portfolios, you often get tracking error. Inevitably, these managers will experience periods of underperformance versus their benchmarks. That said, we believe only those managers that are willing to make concentrated selections at the expense of hugging their benchmark will have the opportunity to outperform over time, net of fees and taxes.

Lifting the Barbell



We believe our carefully defined and allocated client portfolios combine the best of both worlds. In more efficient markets (e.g., U.S. stocks and municipal bonds), we deploy low cost, tax efficient passive vehicles. In less efficient market segments (e.g. European equities, high yield bonds), we often utilize active managers that can add value through skill and unique knowledge of factors that drive securities prices.

In combination, we believe our barbell strategy provides our clients with the best opportunity to outperform over time, net of fees and taxes. To us, that is the bottom line and the power of a barbell approach.

Convergent's Live Well Series is produced to advance dialogue on topics to help people "Invest Well. Manage Well. Live Well.[™]" It is our hope that these articles will illuminate, intrigue, and inspire—and we invite you to join the conversation.

If you have questions, or wish to discuss any of our thought leadership articles, please contact your investment advisor or email us at: LiveWell@ConvergentWealth.com

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