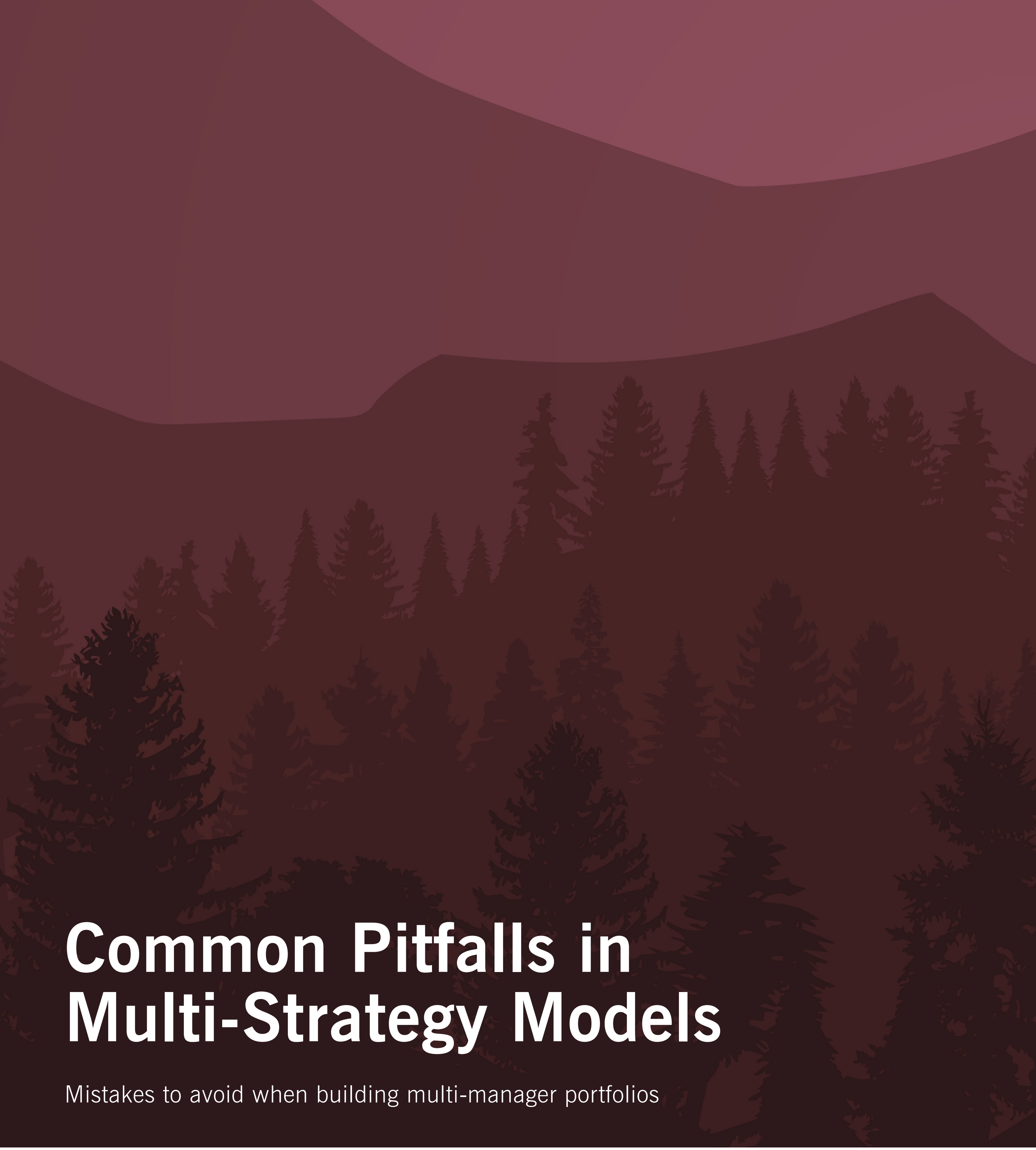

Common Pitfalls in Multi-Strategy Models

Mistakes to avoid when building multi-manager portfolios

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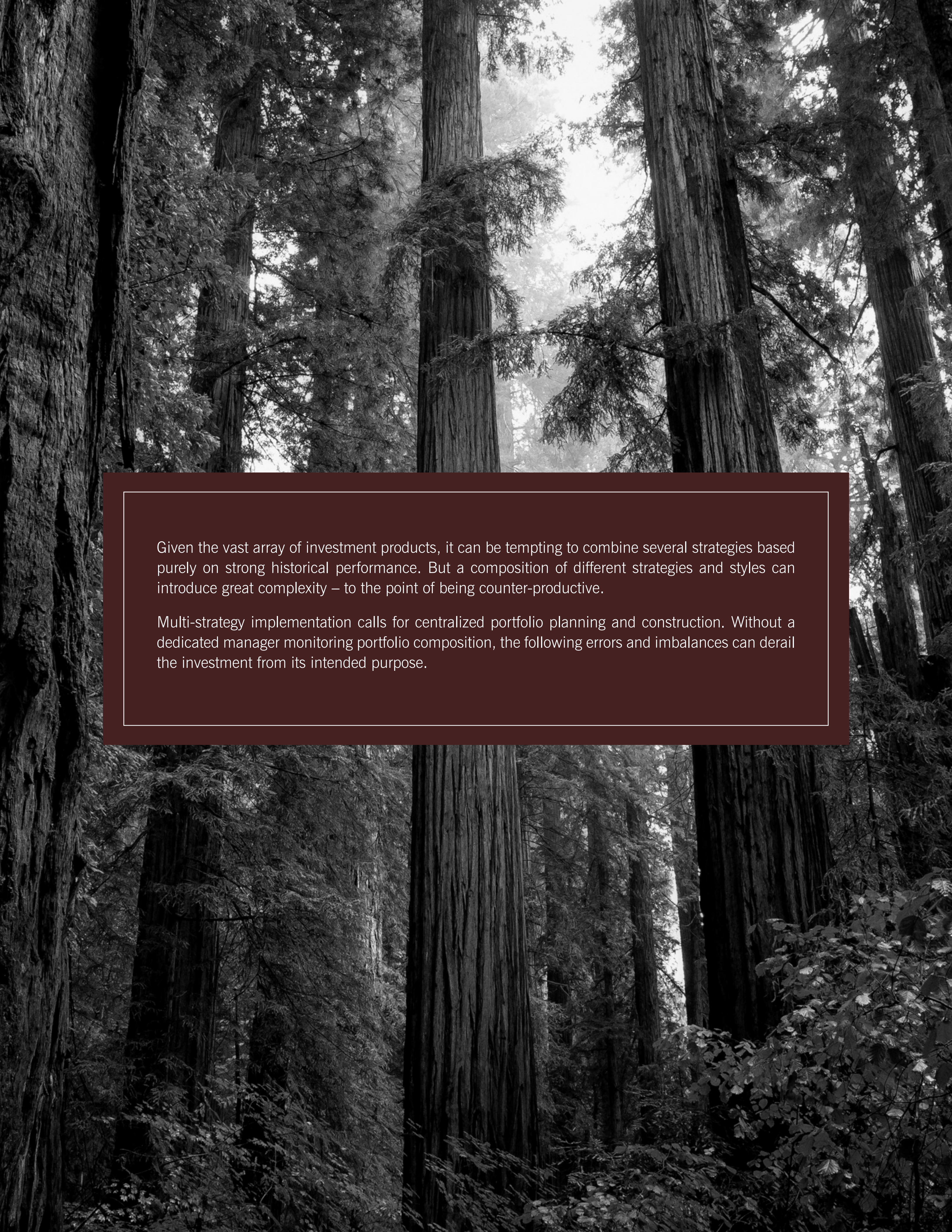

Given the vast array of investment products, it can be tempting to combine several strategies based purely on strong historical performance. But a composition of different strategies and styles can introduce great complexity – to the point of being counter-productive.

Multi-strategy implementation calls for centralized portfolio planning and construction. Without a dedicated manager monitoring portfolio composition, the following errors and imbalances can derail the investment from its intended purpose.

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1 Not Having A Cohesive Investment Plan

Portfolio construction should begin with an explicit plan. It can be difficult to define a single investment philosophy when compiling options from potentially conflicting strategists. But the live management of investments requires clearly articulated answers to certain key questions:

- **What is the maximum amount of any one asset class, any one style, any one strategy?**
- **What is the research process to include – or remove – a manager?**
- **What are the risk and return targets?**
- **What is the general investment philosophy?**

2 Having the Wrong Type of "Diversification"

A portfolio should have diversification in non-correlated strategies or asset classes. Sometimes an advisor finds two "perfect" managers – optimized in a portfolio for the best backward-looking result – only to discover they both do the same thing. Mixing managers may feel like diversification, but they may be susceptible to the same risk types. True diversification transcends performance analytics; it requires deeper due diligence, quantitative analysis, and constant reviews.

A Blending Strategy to Avoid:

	RISK-ON	RISK-OFF	BLEND RESULT
MANAGER 1	High-Yield	Cash	1x High-Yield
MANAGER 2	High-Yield	Cash	1x High-Yield
BLEND RESULT	2x High-Yield	Cash	

Figure 1: Sample portfolio comprising two tactical high-yield managers. Note: when Manager 1 is risk-off, Manager 2 cancels out those strategic efforts. When both are risk-on, a portfolio can have doubled high-yield exposure, and much higher risks. The same can occur when blending managers with overlapping asset allocations, such as two managers who can invest in the Nasdaq 100.

3 Reviewing the Wrong Type of Performance

Evaluating the wrong timeframe can spur poorly researched short-term portfolio changes and manager turnover – ultimately leading to poor long-term results and corrosion of investor confidence. Just because backward-looking calendar years look great does not mean an investor will have the same experience going forward. Rolling time periods can help illustrate the range of potential returns at any point in time, thereby setting more realistic expectations.

4 Over-Optimizing and Allocating to the Wrong Types of Risk

With the technology and databases available today, there is a tendency to over-optimize a portfolio for best returns based on historical performance – without understanding the purpose of different strategies and compositions. The result: overstated returns, understated risk, and misaligned expectations. If picking last year's top-performing stocks delivered the best results, investment professionals would be superfluous. If it doesn't work for stocks, why would it work for managers? Software helps model portfolio returns, but investors should also evaluate mandates, asset classes used, asset class flexibility, and the overall purpose of available strategies.

5 Letting Emotions Drive Investment Decisions

Losing money can get emotional. Newsletters, sentiment, and events can all create a positive or negative bias that can turn a "great idea" into a portfolio allocation change. Without proper research, these ad hoc discretionary changes can divert a portfolio from its intended goal. A series of studies conducted by Dalbar Inc. illustrates that "the average investor earns less – in many cases much less" than mutual fund and benchmark performance.

Performance of the Markets vs. Average Mutual Fund Investor

Dec. 31, 2000 to Dec. 31, 2020

The Dalbar Studies show that after disappointing losses, investors tend to change their allocation to assets that performed better in the same timeframe (cf. Pitfall No. 4). It's not just individual investors; in the absence of a disciplined, quantitative investment management framework and clearly defined expectations, advisors and advisory firms can get caught up in "performance chasing."

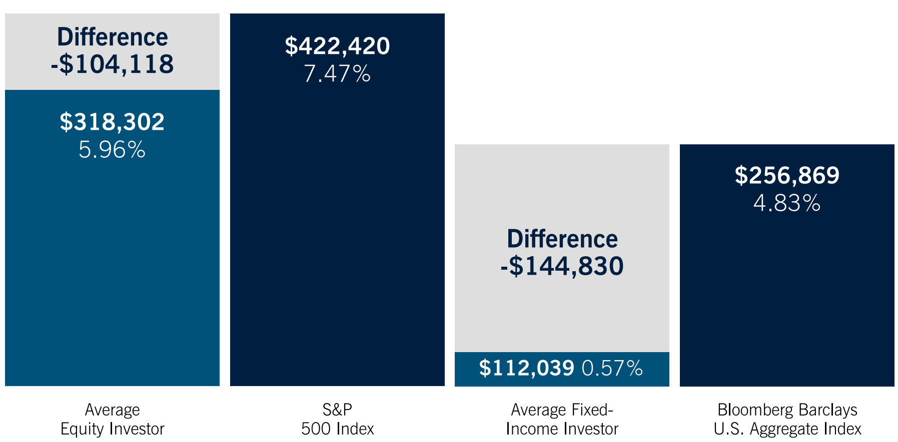


Figure 2: Growth of a hypothetical $100,000 investment (12/31/00 - 12/31/20). The differences between the indices and average investor performances underscore the yields forfeited when emotions lead to the abandonment of an investment strategy.

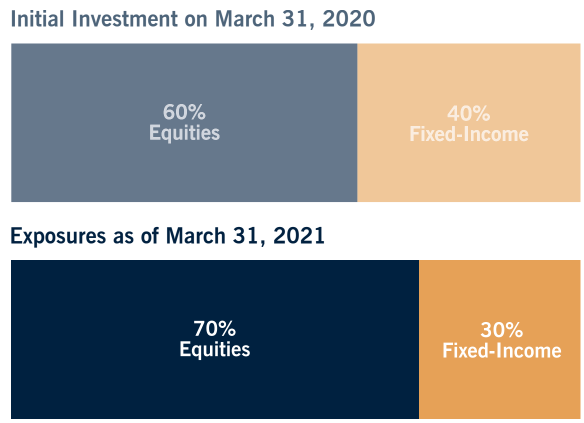
Source: Dalbar. For illustration purposes only. Data as of 12/31/2020.

6 Failing to Monitor Investment Risk

The buy-and-hold approach is often described as long-term and low-maintenance. Yet even with a long-term outlook, it is important to regularly monitor portfolios to identify attributions of returns and losses that can be applicable in different investment environments. Portfolios should be analyzed and managed within guidelines to help ensure they are headed toward their intended targets. A "finger on the pulse" of investment portfolios can build confidence in any market climate.

Figure 3: Sample portfolio of 60% S&P 500 Total Return Index / 40% Bloomberg Barclays U.S. Aggregate Bond Index. This illustration assumes no rebalances or distributions / withdrawals took place. Following the market bottom in March 2020, equities rallied strongly and outperformed fixed income, which caused a dynamic shift in allocation for traditional stock/bond portfolios. Allocation drift can change not only the portfolio composition but also investors' risk exposure.

Source: Bloomberg, Redwood. Data as of 5/31/2021.



7 Lacking Portfolio Customization

It's important for advisors and investors to have the ability to shape risk and return expectations. Allocating to multiple strategies through multiple managers can limit flexibility to customize a portfolio based on its determined goal. For example, you may find a particular tactical strategy necessary in a portfolio that trades small-cap equities. Without full control on a holdings-based level, you may be forced to decide between double the intended exposure or none at all.

There is no perfect process for investment management. But a qualified team can enhance investor outcomes through diligence, effort, and quantitative analysis. Our dedicated investment team has decades of experience tailoring investments to client priorities. We work with analysts and portfolio managers who specialize in equity, fixed-income, tactical, and strategic implementations. Together, we seek to set a risk budget with clear, realistic expectations to achieve desired results.

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