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MULTI-ASSET PORTFOLIOS

Portfolio Structure: Punching above its weight

By Brian Kmetz

For many multi-asset portfolio practitioners, asset allocation and manager selection are the primary focus when constructing an investment portfolio. After all, from an attribution perspective these are the main drivers of return and risk. However, there is an often overlooked return and risk driver that can influence performance in unexpected ways. This overlooked lever is the intermediate step needed to translate an asset allocation into a final portfolio implemented with funds. While there isn't a uniform label for this step, it can be thought of as portfolio structure. In short, portfolio structure is the translation of the asset allocation into an implemented portfolio. Since asset allocation focuses on asset class building blocks, there are many ways to translate those building blocks into a final portfolio.

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Decisions, decisions…

The first structuring decision has to do with the age-old question: use active managers, strictly passive, or a hybrid approach? Another obvious issue revolves around strategies that do not fit neatly into a specific asset class. Think allocation funds, global funds, or idiosyncratic strategies like option overlay or REITs. Finally, within each broad asset class there are style decisions to consider. Keep manager selection broad or split it out by value and growth? Or is there room to incorporate factor-based strategies like minimum volatility? All of these decisions can move the portfolio incrementally away from the initial asset allocation, creating both intended and unintended consequences.

When faced with these questions, an immediate solution is to incorporate more granularity into the asset allocation process (e.g. incorporating the REIT asset class or a growth/value split). But this runs the risk of over-specifying the asset allocation without adding additional value. The optimal asset allocation is one that is granular enough to offer a diversified assortment of asset classes while providing the necessary latitude for selecting appropriate strategies to fit in each bucket (**Figure 1**).

FIGURE 1: Over-specified vs. ideal asset allocation universe

	Over-specified	Ideal
EQUITY	Large Cap Growth Domestic Equity	Large Cap Domestic Equity
	Large Cap Value Domestic Equity	–
	Mid Cap Growth Domestic Equity	Small/Mid Cap Domestic Equity
	Mid Cap Value Domestic Equity	–
	Small Cap Growth Domestic Equity	–
	Small Cap Value Domestic Equity	–
	Domestic REITs	–
	International Developed Growth Equity	International Developed Equity
	International Developed Value Equity	–
	Emerging Markets Equity	Emerging Markets Equity

Source: Natixis Investment Managers Solutions. For illustrative purposes only.

FIGURE 1: Over-specified vs. ideal asset allocation universe (continued)

	Over-specified	Ideal
FIXED INCOME	US Treasury Fixed Income	US Investment Grade Fixed Income
	US Mortgage Backed Fixed Income	–
	US Investment Grade Corporate Fixed Income	–
	International Developed Fixed Income	International Developed Fixed Income
	US High Yield Debt	US High Yield Debt
	US Bank Loans	–
	Emerging Markets USD Debt	Emerging Markets USD Debt
	Emerging Markets Local Debt	–
	Equity	–
	Fixed Income	–

Source: Natixis Investment Managers Solutions. For illustrative purposes only.

Active, passive or both?

With our ideal asset allocation in mind, do we structure the portfolio using passive or active strategies? Passive is the most straightforward from a structuring perspective given that passive funds are representative of pure asset class exposure. Passive portfolios provide both benefits and considerations for end investors. On the benefit side, passive is cheap, easy to implement and eliminates manager selection risk. A major consideration is giving up potential alpha generation and diversification that active managers can provide. With passive, if there are any missteps on the asset allocation side there will not be any manager-specific alpha to offset them. The proliferation of sector, thematic, and factor ETFs is also a gray area for portfolio structuring. Is using a factor ETF that places bets on specific risk premia truly a passive strategy or more active?

With these considerations in mind, a hybrid approach can provide the best of both worlds: cheap asset class exposure using passive with the potential for alpha using active managers **(Figure 2)**. There is also potential for enhanced diversification as an active manager's investment style comes in and out of favor throughout the market cycle. Additionally, there is the luxury of deciding the best ratio of active and passive in the portfolio, with the default a 50/50 split between the two.

FIGURE 2: Active, passive and hybrid portfolios

	Active	Passive	Hybrid
EQUITY	Large Cap Growth Manager Large Cap Value Manager Large Cap Broad Manager	Large Cap Growth ETF Large Cap Value ETF Large Cap Broad ETF	Large Cap Growth Manager Large Cap Value Manager Large Cap Broad ETF
	Small Cap Growth Manager Small Cap Value Manager	Small/Mid Cap ETF	Small/Mid Cap Manager Small/Mid Cap ETF
	Intl. Developed Growth Manager Intl. Developed Value Manager	Intl. Developed ETF	Intl. Developed Manager Intl. Developed ETF
	Emerging Markets Manager	Emerging Markets ETF	Emerging Markets Manager Emerging Markets ETF
FIXED INCOME	US Investment Grade Manager 1 US Investment Grade Manager 2	US Investment Grade ETF	US Investment Grade Manager 1 US Investment Grade Manager 2 US Investment Grade ETF
	Intl. Developed Manager	Intl. Developed Fixed ETF	Intl. Developed Manager
	US High Yield Debt Manager	US High Yield ETF	US High Yield Debt Manager US High Yield ETF
	Emerging Markets USD Debt Manager	Emerging Markets USD ETF	Emerging Markets USD Debt Manager
	Equity	–	–
	Fixed Income	–	–

Source: Natixis Investment Managers Solutions. For illustrative purposes only.

Accounting for specialized strategies

In addition to active and passive usage, strategies that do not fit neatly into an asset class bucket can present challenges for investors. Ideally, each strategy fits cleanly into an asset class and performs its designated role. The underlying exposures are understood and style drift is not a day-to-day concern. Strategies like REITs, global allocation funds, or hedged strategies can cause headaches when implementing them in an equity and fixed income asset allocation. One solution is to create a separate sleeve to hold these strategies, funding the sleeve from equity and fixed income so the beta profile of the incorporated strategy matches the beta profile of the equity/fixed funding source (Figure 3).

FIGURE 3: Funding a global allocation sleeve

	Portfolio	Portfolio Pre-Global Allocation	Changes to Fund Global Allocation Manager	Portfolio Post-Global Allocation	Global Allocation Manager Asset Class	Global Allocation Manager Breakdown
EQUITY	Large Cap Growth Manager	10.5%	-0.8%	9.7%	Large Cap Equity	30%
	Large Cap Value Manager	10.5%	-0.8%	9.7%	Small Cap Equity	7%
	Large Cap Broad ETF	18.0%	-1.4%	16.6%	Intl. Developed Equity	23%
	Domestic Equity Sleeve	**39.0%**	**-3.0%**	**36.0%**		
	Small/Mid Cap Manager	2.5%	-0.4%	2.2%	US Investment Grade	35%
	Small/Mid Cap ETF	2.5%	-0.4%	2.2%	US High Yield	5%
	Small Cap Equity Sleeve	**5.0%**	**-0.7%**	**4.3%**		
	Intl. Developed Manager	6.5%	-1.2%	5.4%		
	Intl. Developed ETF	6.5%	-1.2%	5.4%		
	Intl. Developed Equity Sleeve	**13.0%**	**-2.3%**	**10.7%**		
	Emerging Markets Manager	2.5%	–	2.5%		
	Emerging Markets ETF	2.5%	–	2.5%		
	Emerging Markets Equity Sleeve	**5.0%**	–	**5.0%**		
FIXED INCOME	US Investment Grade Manager 1	10.0%	-1.1%	8.9%		
	US Investment Grade Manager 2	10.0%	-1.1%	8.9%		
	US Investment Grade ETF	12.0%	-1.3%	10.7%		
	US Investment Grade Sleeve	**32.0%**	**-3.5%**	**28.5%**		
	Intl. Developed Manager	0.0%	–	0.0%		
	US High Yield Debt Manager	1.5%	-0.3%	1.3%		
	US High Yield ETF	1.5%	-0.3%	1.3%		
	US High Yield Sleeve	**3.0%**	**-0.5%**	**2.5%**		
	Emerging Markets USD Debt Manager	3.0%	–	2.0%		
	Global Allocation Manager	**0.0%**	**10.0%**	**10.0%**		
	Equity	Active Strategy Share: 57.0%	–	Active Strategy Share: 61.4%		
	Fixed Income	Passive Strategy Share: 43.0%	–	Passive Strategy Share: 38.6%		
	Global Allocation	–	–	–		

Source: Natixis Investment Managers Solutions. For illustrative purposes only.

A question of style

The final structuring decision takes place within each asset class and addresses style selection. The most elementary question being: split by growth and value or stay broad? This is where the gray area of active/passive also comes into effect: is it better to use thematic and factor ETFs or stay true to each asset class? With the prevalence of choice it is easy to fall down the rabbit hole of style selection and never escape. The simplest way to make a decision is to assess where the comfort zone lies. If conviction on growth vs. value is low, staying broad is the best bet. If timing sector or factor rotation isn't a strength, then keeping a strategic allocation to certain factor exposures or avoiding them altogether are good options **(Figure 4)**.

The bottom line

These examples help demonstrate why portfolio construction isn't a straightforward exercise. It goes beyond merely generating an asset allocation and then implementing with strategies. The intermediate step of portfolio structuring is just as valuable and may offer an additional source of alpha potential. Not understanding the tradeoffs for certain decisions can introduce uncompensated risks that manifest at inopportune times. A flood of new products and strategies can make the structuring decision overwhelming, and in those times the adage "keep it simple" rings true.

FIGURE 4: Adding factors and themes

	Portfolio	Weight	Portfolio with Factors/Themes	Weight
EQUITY	Large Cap Growth Manager Large Cap Value Manager Large Cap Broad ETF	10.5% 10.5% 18.0%	Large Cap Growth Manager Large Cap Value Manager Large Cap Broad ETF Quality Factor ETF	10.5% 10.5% 12.0% 6.0%
EQUITY	Small/Mid Cap Manager Small/Mid Cap ETF	2.5% 2.5%	Small/Mid Cap Manager Small/Mid Cap ETF	2.5% 2.5%
EQUITY	Intl. Developed Manager Intl. Developed ETF	6.5% 6.5%	Intl .Developed Manager Intl. Developed ETF Intl. Small Cap ETF	6.5% 4.0% 2.5%
EQUITY	Emerging Markets Manager Emerging Markets ETF	2.5% 2.5%	Emerging Markets Manager High Dividend Emerging Markets ETF	2.5% 2.5%
FIXED INCOME	US Investment Grade Manager 1 US Investment Grade Manager 2 US Investment Grade ETF	10.0% 10.0% 12.0%	US Investment Grade Manager 1 US Investment Grade Manager 2 US Investment Grade ETF US Investment Grade Corporate ETF	10.0% 10.0% 8.0% 4.0%
FIXED INCOME	Intl. Developed Manager	0.0%	International Developed Manager	0.0%
FIXED INCOME	US High Yield Debt Manager US High Yield ETF	1.5% 1.5%	US High Yield Debt Manager US Bank Loan Manager	1.5% 1.5%
FIXED INCOME	Emerging Markets USD Debt Manager	3.0%	Emerging Markets USD Debt Manager Emerging Markets Local Debt ETF	1.5% 1.5%
	Equity	Active Strategy Share: 57.0%	–	Active Strategy Share: 57.0%
	Fixed Income	Passive Strategy Share: 43.0%	–	Passive Strategy Share: 43.0%

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