Morningstar Investment Management Insights
The12-Step Process to Building a Great Multi-Asset Fund

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For Financial Advisers

Key Takeaways

- To build a robust fund, we believe 12-steps need to be agreed and practiced consistently.
- This process helps take a complex operating system and simplifies it into actionable stages.
- This is the structure that all multi-asset funds and portfolios overseen by Morningstar Investment Management follow, providing dependability of approach.

Investing is often about taking the complex and simplifying it into digestible and relevant chunks. If this can be done repeatedly, you're well on your way to healthy risk-adjusted returns. With this in mind, we thought it would be useful to highlight why we decided on a 12-step process that can be consistently used for fund and portfolio construction—including why this helps an investor to reach their goals.

To start, we must agree that building anything worthwhile requires three core pieces of knowledge. We've drawn a parallel with how one would select a sports team, but the same applies if building a house, building a ship or building a fund or portfolio:

- **Appreciate the rules**—know the goal, including the parameters and any constraints.
- **Rank the players**—obtain a thorough understanding of each implementation option, accounting for both the expected reward and any associated risk.
- **Select the team**—take all available information, consider how each implementation option might work together and find the most appropriate overall solution.

Of course, we must highlight that this process is iterative. We never know how a given player will perform on a given day, nor whether a storm will hit, but if the framework is holistically followed it should produce results over the long term. Turning this into a specific investment framework, the 12-steps we believe are best placed to help investors are as follows:

The Mandate	**1.**	Outlining investment objectives
	2.	Identify fund or portfolio constraints
	3.	Determine fund or portfolio construction rules
	4.	Identify investments available for inclusion
Investment Landscape	**5.**	Understand reward versus risk
	6.	Assigning conviction levels
	7.	Ranking the opportunity set
Portfolio Progress	**8.**	Producing all feasible fund or portfolio iterations
	9.	Development of fund or portfolio quality characteristics
	10.	Identify the most attractive fund or portfolio composition
	11.	Iterate fund or portfolio sizing
	12.	Finalise fund or portfolio allocations

Collectively, these steps allow us to deliver a clear investment process that increases the likelihood of reaching an investors' goals. For further context, we now attempt to peel back some of the jargon and run through each of the 12 steps in order.

1. Outlining Investment Objectives

It is paramount that we emphasise the importance of the first step—to be clear on the objective. Without this grounding, we risk being boundless and haphazard. This goals-based approach is essential to your success and is a common feature across every portfolio Morningstar Investment Management oversees. With a clearly-defined objective in mind, we are then in a position to identify the appropriate parameters, constraints and fund or portfolio construction rules to achieve the given mandate.

2. Identifying Fund or Portfolio Constraints

This is our forward defense and a part of the process we pay particular attention to. When identifying the parameters, constraints and rules we will take into account a variety of factors, but the main considerations are as follows:

- The minimum time horizon of an investor profile
- Any risk limits of the investor profile
- Any limitations to the investment universe
- Controls to avoid concentration risk (for example, maximum exposure to a currency)

3. Determining Fund or Portfolio Construction Rules

This step guides the construction of funds or portfolios that allocate the most capital to the most attractive opportunities and build positions over time to intelligently align position sizing with investment conviction levels. To build out the rules of engagement, we might consider the following examples in this step:

- Position ranges—for example, if the smallest position should exceed a certain level.
- Position size steps—for example, whether positions should increase or decrease by minimum increments.
- Low risk/defensive position sizing—for example, whether cash is considered the default asset when the opportunity set is unattractive.
- Turnover – a maximum turnover level set for the strategy.

4. Identifying Investments Available for Inclusion

Once we have agreed on the mandate and the rules of engagement, we look to populate a fund or portfolio with the best possible investments. Underlying this, we know that asset allocation decisions will be a key driver of outcomes, so we place a meaningful emphasis on the valuations offered by various asset classes. We also couple this with a comprehensive investment selection framework, including monitoring our preferred investment vehicles.

It is worth noting from the outset our process is not robotic or overly quantitative. Instead, our asset allocation process follows a consistent and disciplined manner that considers how attractive eligible investments are relative to the rest of the investment universe.

The below list provides a guide to the asset allocation universe considered by Morningstar Investment Management, although the list is not necessarily exhaustive.

Equities

200 markets and sub-markets including:

- US Equity by Style, Size and Sector
- UK Equity Style, Size and Sector
- European Equity (ex UK)
- Asia Pacific (ex Japan)
- Emerging Markets
- Japan

Fixed Income

150 markets and sub-markets including:

- Government Bonds
- Corporate Bonds
- Inflation Linked Bonds
- Global High Yield
- Emerging Market Debt
- Cash

Currency

Over 30 currencies including:

- US dollar
- Pound sterling
- Euro
- Japanese yen
- Chinese yuan

Alternative Assets

Various alternatives including:

- Infrastructure
- Real Estate (Global REITs)
- Commodities
- Hedge funds
- Commercial Property

In this regard, we must acknowledge that the investment universe is vast and complex, with tens of thousands of open-ended funds in operation and many more direct equities and bonds. On any given day, we could see a new entrant, a merger or a wind-down of a fund. We can also see changes within each fund, such as the departure of a regarded manager or new staff with conflicting styles. This imposes a further risk to the fund or portfolio management process and therefore requires careful attention.

At the heart of the qualitative investment selection process is the concept of a three-pillar rating structure. These pillars - People, Process and Parent - are used by both the Morningstar Manager Research team and the Morningstar Investment Management group and it serves as the backbone of the investment selection appraisal approach. The process by which we move from analytical research to making selection decisions involves the construction and ongoing maintenance of a “Buy-list”.

In this sense, finding investment opportunities isn’t just about great ideas; it’s also about selecting investments that complement each other and play an active role in fulfilling the ultimate objective. From an asset allocation and investment selection perspective, this commences with a thorough understanding of the playing field we operate in and requires a deep understanding of what role each asset class has in a fund or portfolio.

5. Understand Reward Versus Risk

Risk management at a fund or portfolio level can be complex, multifaceted, and vary over time. Our definition of investment risk (the ‘permanent loss of capital’), means we believe one of the best ways to control for risk is to buy strong investment vehicles in fundamentally strong asset classes. Integral to all of our analysis, we want to have a firm handle of whether we are taking the appropriate amount of risk given our view on markets.

To do this, we apply valuation analysis supported by in-depth fundamental research to find opportunities. We seek to buy overlooked investments, especially those that offer sound fundamentals at an attractive price. Our valuation analysis tells us how attractively priced an investment is, while insight of the fundamental drivers of asset prices increases the probability that we will get more than we pay for. For this reason, valuations and risk are joined at the hip.

Ultimately, this part of the fund or portfolio construction process supports the fact that portfolios are managed with a clear understanding of risk as well as the expected rewards on offer.

6. Assigning Conviction Levels

Investing requires us to be independent and curious; continually evolving and searching for better ways to allocate money. Therefore, even with the benefit of a broad opportunity set, investing requires experience, dedication and the application of a robust and repeatable asset allocation process.

This judgment-driven approach allows us to maximise our exposure to our best investment ideas and accounts for the complexity and multifaceted nature of investment risk. We unlayer these convictions and rank each asset via four means:

- **Absolute valuation** – we want a clear understanding of what each asset can be expected to deliver over a 10-year time horizon.
- **Relative valuation** – we want to understand how well the asset ranks compared to other markets.
- **Contrarian sentiment** – we want to identify whether current sentiment is supportive to our conviction in a long-term context.
- **Fundamental risk** – we want to clearly understand the range of possible scenarios, as well as any risk that would cause a judgement error.

7. Ranking the Opportunity Set

Investing is about the ranking of our convictions and risk management. So, armed with our analysis— our global team works together to rank the available investment universe. We seek to gain the largest exposure to our best ideas that are the most underpriced (that is, have the largest difference between price and fair value), while building robust asset allocations designed to stand up to challenging investment environments or investment errors.

Underpinning this, we know that if valuation-driven investors are to succeed they must do so unconventionally. They must overcome their biases and often go against the views of their peers. Many investors lack the mental toughness to do this, which is why few are able to beat the market benchmark over a long period of time. For this reason, we will continue to monitor sentiment as a part of our capital markets research, seeking to take a contrarian approach. The general idea is to be overweight to assets with poor sentiment and vice versa.

In practice, we compile a ranking of the investment universe to understand the landscape in a structured manner.

8. Producing All Feasible Fund or Portfolio Iterations

An extremely important evaluation as we monitor funds or portfolios is how the selected investments complement each other. This part of the process involves qualitative judgements which is supported by due diligence testing. This is built around a variety of factors, including any style and size biases, as over the long term, investors may or may not benefit from having this exposure.

In many cases, it is not determining the fair value itself that is confronting, but rather what you do when the price is very different from fair value. We continue to believe a willingness to be different and act on large differences between price and fair value is essential for long-term success.

While this part of the investment process is far more qualitative than quantitative, we will utilise an array of tools where appropriate to allow for decisions to be made with the greatest sense of confidence. We perform due diligence on all fund or portfolio iterations—using both Morningstar Investment Management proprietary measures and standard practices—to arrive at our highest conviction ideas.

9. Development of Fund or Portfolio Quality Characteristics

The next step is to pull this together into a fund or portfolio context. It is therefore important to understand risk and return looking ahead into the future, not looking at the past, just like it would not be safe to drive a car looking only in the rear-view mirror. Our research produces insight into not only future investment opportunities but also their attendant fundamental drivers of risk. By better understanding these forward-looking risk drivers, we can diversify funds or portfolios for the future rather than basing these decisions on the past.

For example, we may consider deflation and negative economic growth to be a key risk for a multi-asset fund or portfolio. While bonds may perform well in this environment, we may end up paying a very high price for this protection, akin to overpriced insurance. This is an expensive strategy that tends to lose value in most environments given the high prices paid.

It is therefore about more than just spreading your eggs, as it's possible for investments in different asset classes to be affected by the same economic developments.

10. Identifying the Most Attractive Fund or Portfolio Composition

The primary objective of this stage of the process is to ensure concentration risk is mitigated and that any decision regarding a fund or portfolio has a clear idea of what risks may be apparent and what mix of investment types may provide the greatest risk-adjusted returns. Inherently, all assets should not be expected to perform well simultaneously.

In order to accomplish this, we apply a robust risk methodology to evaluate asset overlap. This involves analysis of risk, along with traditional correlation assessments to see how complementary they are within the overall framework. The goal is to establish a specific role for each asset to play in the overall investment mix. With access to this insight and conviction surrounding our investment process, we can then implement an effective total customer solution. Risk management is therefore at the heart of this part of the process, which can be accommodated in conjunction with our investment selection framework.

11. Iteration of Portfolio Sizing

With a firm idea of how the fund or portfolio will behave, we are in a position to populate our views with the right investment vehicles. This means the team can focus the exposure of the fund or portfolio on the best ideas (that is, selections we believe have the greatest likelihood of outperforming), while maintaining diversification in our selection process. This is designed in such a manner that it can stand up to challenging investment environments.

As a part of this process, Fund or Portfolio Managers are required to consider the following investment considerations:

- Why do we own it (or should we own it)?
- What role does it play?
- What are our expectations?
- What are the issues/risks?
- What would cause us to sell it?

12. Finalising Holdings

Taking all of the above, we are finally in a position to select the most appropriate solution. This judgment-driven stage allows us to maximise the potential of the fund or portfolio and account for the complexity of investment risk. To prepare investors for the future, the investment team use their expertise to construct robust investment solutions designed to perform well in different environments rather than being considered "optimal" based on expected results or a specific environment.

As a general rule, we avoid short-term forecasts based on one's ability to predict specific environments. Instead, we aim to prepare for different environments through constructing portfolios that will hold up under many possible scenarios—even ones that we haven't seen before. In effect, this involves trade-offs to deal with the probability and impact of negative outcomes.

This provides accountability and ultimately helps ensure the outcomes are in line with the best interests of an end-investor. We hope you found this summary useful and that it offers comfort.

Further information

Please contact Morningstar Investment Management on 0203 107 2930 or at funds@morningstar.com for further information.

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