Building the Right Team for Your Client Portfolios

How to select and combine managers and investment vehicles

Not FDIC Insured • May Lose Value • No Bank Guarantee

For investment professionals.

FIDELITY INSTITUTIONAL ASSET MANAGEMENT®

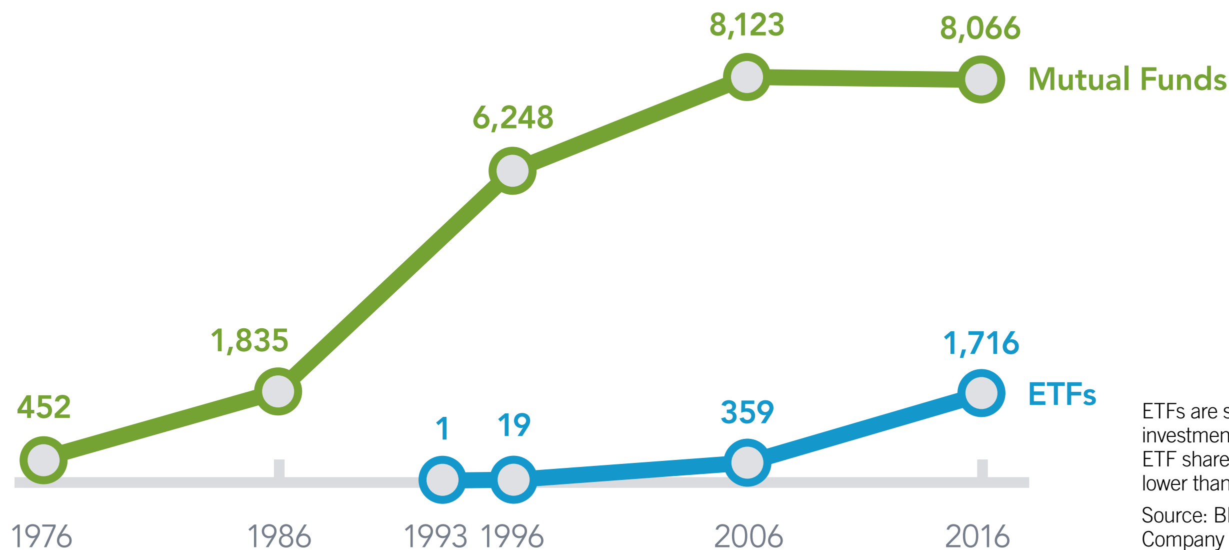
A changing investment landscape creates challenges and opportunities

Manager selection means choosing a specific set of investments to fill out your clients' portfolios. A due diligence process focused on each potential mutual fund, ETF, or other investment vehicle you might recommend or use is an integral part of an investment plan—an important way to help your clients achieve their goals.

As an advisor today, you face a vastly expanded universe of mutual funds and ETFs. The rapid growth in the number and type of investment options has made manager selection more complex. In addition, a rapid transition to fee-based advisory models, an evolving fiduciary environment, and ongoing innovations in financial technology have shaped the way you evaluate investments and build portfolios.

Despite the challenges and complexity, this landscape in flux creates an exciting opportunity for you to distinguish yourself, and thrive, with an efficient framework for manager selection.

The number of investment options available to choose from has increased significantly over the past 40 years.



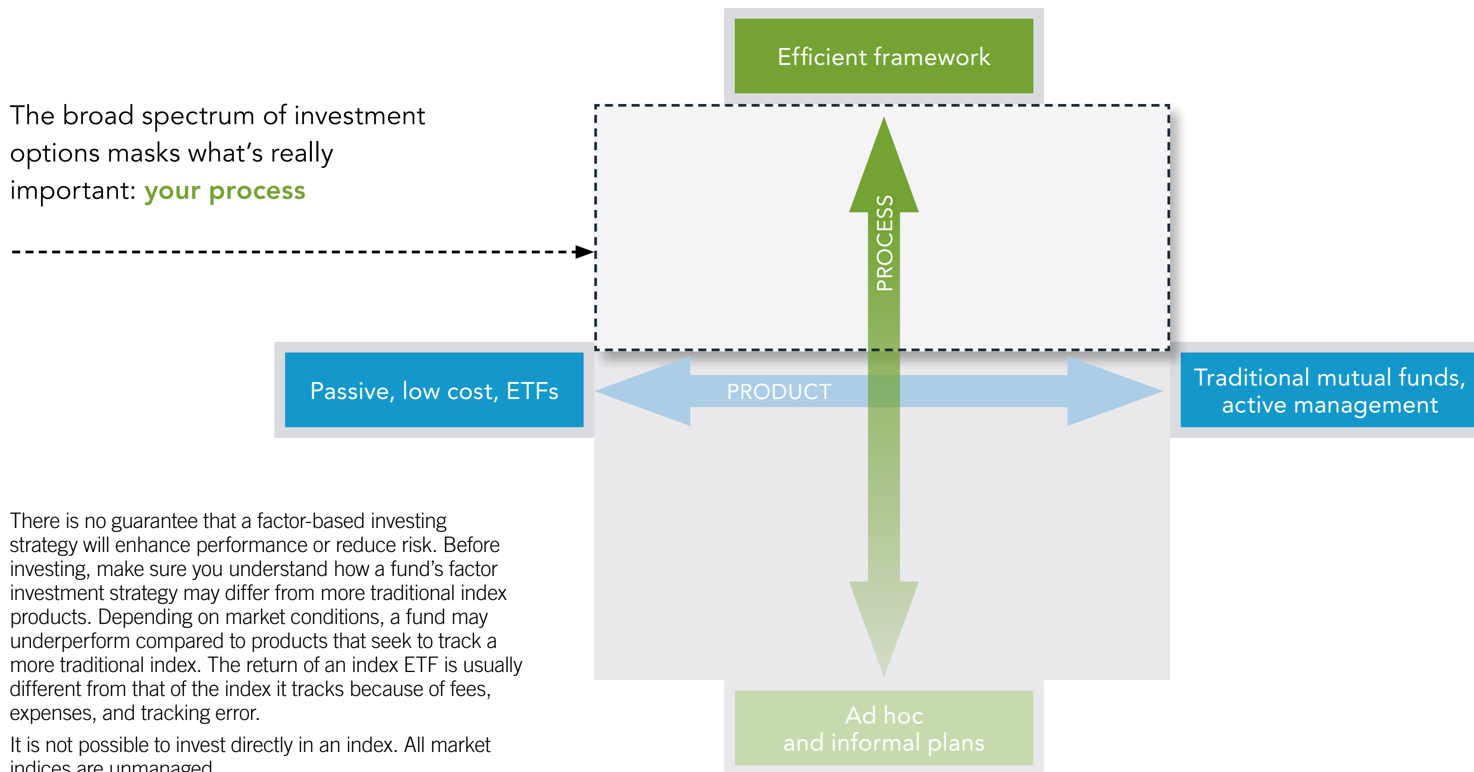
ETFs are subject to market fluctuation, the risks of their underlying investments, management fees, and other expenses. Unlike mutual funds, ETF shares are bought and sold at market price, which may be higher or lower than their NAV, and are not individually redeemed from the fund.

Source: Bloomberg, Investment Company Institute Fact Book, Investment Company Institute, http://www.ici.org, as of Dec. 31, 2016.

Focus on process, not just product

On one end of the spectrum, there are traditional active funds built on fundamental analysis and a deep understanding of the market and the economic environment. At the other extreme, passive index funds and ETFs seek to provide low-cost market exposure. Between them is a wide array of hybrid approaches, including enhanced index funds and smart beta or factor-based strategies.

As a client-centric advisor, you may want to focus on being able to recommend and use a full range of investment products to help your clients reach their financial goals. What matters most from the fiduciary standpoint may not be the type of products you recommend, but your process for assessing them and matching them to each client's objectives.



There is no guarantee that a factor-based investing strategy will enhance performance or reduce risk. Before investing, make sure you understand how a fund's factor investment strategy may differ from more traditional index products. Depending on market conditions, a fund may underperform compared to products that seek to track a more traditional index. The return of an index ETF is usually different from that of the index it tracks because of fees, expenses, and tracking error.

It is not possible to invest directly in an index. All market indices are unmanaged.

A traditional approach to manager selection

With a range of investment options to select from, you can aim to build a "championship team" of investments for your clients' portfolios, to help them reach their goals.

See "Starting Points for Research: The Six Ps of Manager Selection," page 10.

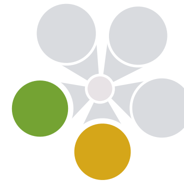
For investment professionals.

Evolve your process

The "Five Ps" used by Morningstar and others is a familiar approach to manager selection. By assessing **parent, people, process, performance,** and **price,** advisors can follow a repeatable and documented process for comparing investment options.

Based on our own experience designing multi-manager portfolios—and thousands of consultations with successful advisors—we've identified three ways to enhance your approach to building portfolios.

Consider how parent, people, and process can overlap.



Think about how performance and price combine to help determine value.

Add a "Sixth P": portfolio—consider how managed investments interact with one another.

Using parent, people, and process together

Parent, people, and process are each important considerations in their own right, but how they interact can be even more powerful. In fact, a close look at the parent fund family is an integral component of manager selection, because an individual fund's people and process typically do not exist in a vacuum.

Parent often sets the tone for individual funds, and may even enhance a manager's skill

A manager's process and philosophy often reflect the fund family's shared risk culture and overall approach to investing. Understanding how the fund family's heritage and research resources might amplify the manager's strengths is also important. For example, a manager focusing on fundamental analysis may benefit from a fund family with strong research capabilities.

The fund family supplies the operational resources to translate active insights into portfolios. Ensuring that a parent can do this efficiently, while helping to keep risk and costs low, is a critical requirement. Consider how a manager's people and process give the fund potential advantages over its peers. Then ask: Is that advantage supported by the parent fund family?

The way a fund family recruits and trains future generations of portfolio managers is also of central importance, as it conveys a parent's ability and willingness to continually invest in the quest for outperformance.

For parent, scale matters

The fund family's sheer size may also support performance. Our research has shown that for mutual funds focusing on U.S. large cap equity, fund families with more assets under management in that asset class have outperformed their peers on average, over the long term.[1] This applies to both active and passive funds, as economies of scale can help to both raise excess returns (active) and lower expenses (active and passive).

Performance + price = value

It's the most common disclaimer in finance: An investment's past performance does not dictate its future returns, and therefore it shouldn't be the sole consideration when evaluating a manager. Yet many investors continue to favor funds based on simple screens for historical, risk-adjusted returns net of fees. For example, from 2012 to 2016, about 120% of estimated net flows went to Morningstar 4-star and 5-star funds.[2] A strong manager selection process should include a more nuanced examination of past performance and what it can tell you about an investment.

Understanding returns, in context

Focus on educating your clients on how to understand performance across the various building blocks of a portfolio. That means assessing returns not simply against "the market" or other investments. It also means communicating how performance fits within the context of the portfolio's overall investing goals, risk management, and time horizon. A manager selection process that explicitly considers performance in these ways can be more explainable to clients.

Moreover, breaking down the components of performance can be helpful in assessing a mutual fund or ETF. For example, risk measures such as tracking error or upside/downside capture tend to be more persistent than returns themselves. For actively managed funds, the underlying sources of return can tell you about a manager's potential strengths and weaknesses.

Finding value

For price, start with a clear understanding of the full cost of an investment (including expense ratio, sales fees, trading costs, etc.). It should be competitive relative to the costs of comparable peers. As you compare products across the spectrum of management approaches, consider cost as a component of value.

A focus on performance net of fees is a good starting point toward thinking about value. Although an active fund may be more expensive than its passive counterparts or even some active peers, if the outlook for returns net of fees is superior (based on the manager's skill or resources), then the added cost may be reasonable. And if a client's investment objectives require that a portfolio outperform a benchmark or that risk be managed intentionally, carefully selected active investments may prove the better value, despite a potentially higher cost.

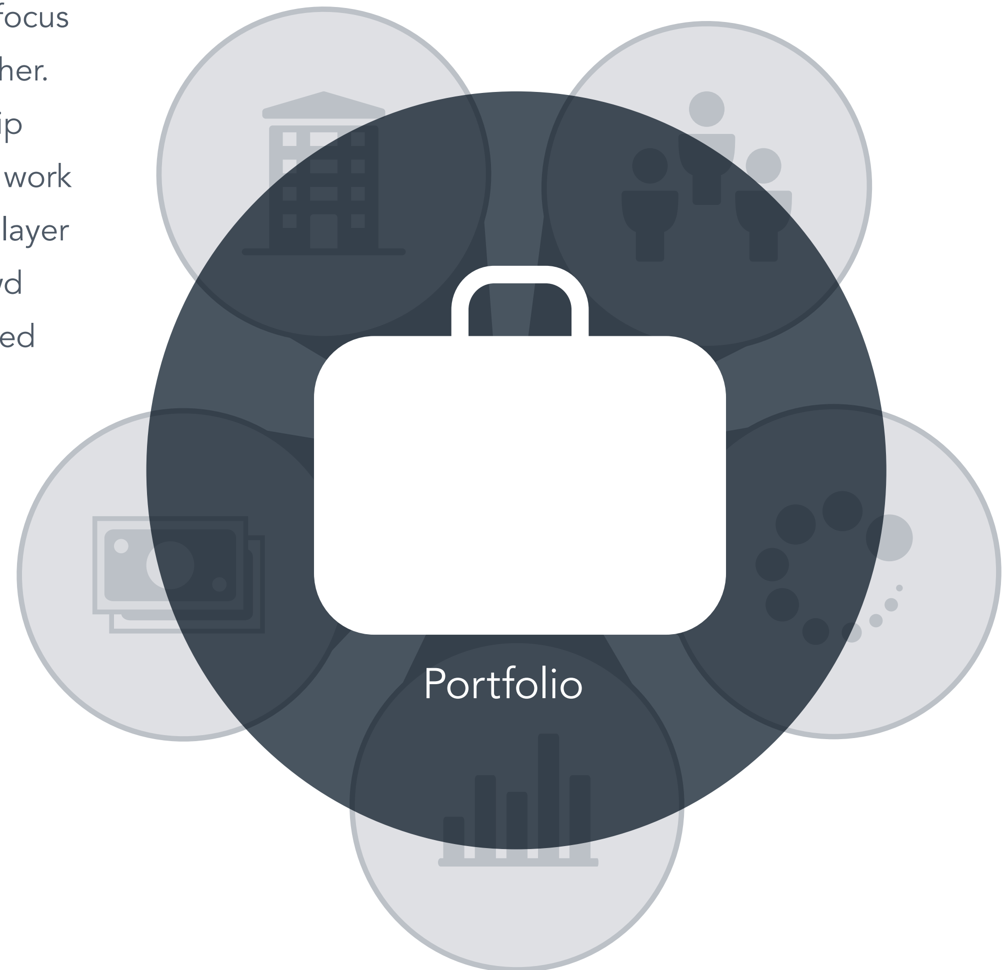
The Sixth P: Portfolio

Manager selection within a comprehensive portfolio should focus on how the portfolio's building blocks interact with one another. A helpful sports analogy is that of assembling a championship team rather than an all-star team—selecting the players that work best together as a team, rather than trying to find the best player for each position. In practice, this may include avoiding crowd favorites in favor of managers with skill sets that appear poised to add value within a diversified portfolio.

Consider two broad implications for portfolio construction:

1. **Don't hesitate to consider a mix of active and passive investment options**

2. **Don't restrict yourself to managers who fit in narrow boxes**



There are several approaches to combining active and passive investments

Across market categories, some advisors recommend and use actively managed funds whenever they have high conviction about particular managers. Others focus active management on categories where the average active funds have tended to outperform passive funds (e.g., international equities, U.S. small cap equities, and investment-grade bonds), where index funds may have difficulty tracking a benchmark (e.g., municipal bonds), or where available benchmarks may not match the desired exposures.

However, even within every category, portfolios can blend active and passive funds and index funds to attain the degree of risk and potential outperformance that meets clients' overarching needs. For example, a client with a large allocation to U.S. large cap equity may seek outperformance but may also be mildly averse to the risk of underperforming the market. That client's portfolio could hold multiple funds in the category, including a low-cost index fund and several well-selected actively managed funds, to balance both risk and potential reward.

Look beyond style purity

Many institutional consultants praise style-pure managers: those with constant weightings to a certain style, market capitalization, or factor, such as momentum, quality, or low volatility. But for many of the best managers, their ability to pursue opportunities across styles and exposures is precisely what keeps them ahead.

When building portfolios for clients seeking outperformance, consider starting with a few great managers as a strong foundation, and then carefully fill out the portfolio with complementary strategies.

Counterintuitively, passive funds may not be truly style-pure either, in that their exposures can drift with market capitalization. For example, in 1999 (during the tech bubble), technology stocks represented 29% of the S&P 500 Index, versus a longer-term average of 18%.[3] Likewise, the U.S. bond market went from 17% of total capitalization in Treasury bonds in 2006 to 36% in 2016.[4] A manager selection process that focuses on the client's overall portfolio may want to examine the underlying exposures of all investment options, seeking to combine them into a "championship team" that more accurately addresses the client's overall investing goals.

As always, keep an eye on the big picture: a portfolio's asset allocation and the macroeconomic backdrop. As economic conditions ebb and flow over the course of the business cycle, the manager lineup, like the overall allocation, may require adjustments. And in many cases, investing in the right markets may be more important than pinpointing the perfect investment vehicle.

Key Takeaways

- When evolving your process for choosing and combining investments, consider a wide range of options to create portfolios that can help your clients reach their goals.
- The familiar Five Ps are effective tools for sifting through the candidates, but they can be even more powerful when combined with one another.
- Develop a deep understanding of each investment's parent, and of how its performance and price combine to determine its value.
- Adding the Sixth P: portfolio, opens new possibilities for combining active and passive investments and for building portfolios around the unique qualities of the best available managers.
- A well-constructed framework to confidently evaluate, recommend, and use a broad range of investment options can help you deliver top-quality investment management, guide meaningful conversations with your clients, and more comprehensively address their needs and goals.

"The Six Ps of Manager Selection," on the next page, can help you get started.

Asset allocation and diversification do not ensure a profit or guarantee against a loss.

Starting Points for Research: The Six Ps of Manager Selection

Parent

The overarching fund family, which can have a strong influence on managers

- How durable and stable is the organization?
- Is the fund family a responsible steward of investors' capital?
- What kinds of risk and compliance controls are enforced by the fund family?
- Does the fund family provide research, trading, and administrative resources that can reduce expenses or potentially increase returns?
- Are incentives and controls appropriately aligned with investment and shareholder objectives?
- What is the firm's risk culture, with regard to investing client assets and its own?

People

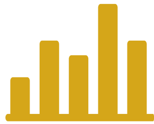
The quality and skill of a fund's management team

- What is the tenure and record of the management team?
- For active managers, how does the team conduct research?
- For passive managers, what expertise does the team apply in replicating the benchmark index?
- How is the management team compensated?
- Is there a common understanding of process and philosophy across all critical investment functions?
- What is the typical recruitment and training path for analysts and portfolio managers?
- How does the management team address consensus investment views?
- How does the management team deal with setbacks and paradigm shifts?

Process

The specific investment philosophy and investing practices applied

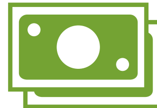
- What are the manager's objectives and philosophy, and how does the investment process support them?
- How is information about securities collected and combined to determine buy/sell decisions?
- How does the management team make decisions (single PM, committee, etc.)?
- Are there constraints on industry, sector, factor, or security exposures, and do such limits give the management team adequate room to maneuver?
- What risk-management procedures are designed to protect investors?
- What about the investment approach or philosophy might set the manager apart?
- Is the strategy based on a systematic approach, or is expert situational judgment emphasized?
- How might the economic environment influence investment decision-making?
- For factor-based and enhanced-index approaches, does the index methodology reflect fundamental insights?
- How are new investment ideas sourced, and what is the team's sell discipline?



Performance

The manager's performance
in the past

- How have past returns compared both to benchmarks and to comparable peers?
- What are the risk-adjusted returns?
- How consistent has past performance been over various holding periods?
- For active managers, what has been the excess return, information ratio, tracking error, and upside/downside capture?
- For passive managers, what has been the tracking error and upside/downside capture?
- What have been the historical sources of return?
- How did the strategy fare during actual market downturns?



Price

The full expenses
an investor must pay

- How do the expense ratio and other fees compare to direct peers?
- How might trading fees, bid/ask spreads, and other costs beyond expense ratio affect investors?
- What features of the investment option contribute to its value for investors, and therefore, what is its price/value tradeoff?

You bring it all together for your clients

Portfolio

The interaction of individual investment players to form a "championship team"

- How attractive is this investment option within the context of a diversified portfolio, relative to potential substitutes?
- Which client portfolios might this fund belong in?
- Can a blend of investment types (active and passive) help fine-tune the risk-return potential of the portfolio?
- How might this investment option change the overall portfolio's characteristics?
- How should the position be sized?
- Does the overall portfolio reflect the client's investing goals and preferences?
- How can this strategy be explained to clients, and what can they expect from it?

When comparing funds, please consider all important factors, including information pertaining to fund fees, fund features, and fund objectives. While funds may track an index, the indices and strategies employed in seeking to achieve an investment goal may be different. Each fund's investment objective and strategy and index tracked to achieve investment goals may differ.

No matter where you are today, we'd like to help.

Review Our Original Insights

Visit institutional.fidelity.com for actionable perspectives supported by extensive research:

- Regularly published white papers and Viewpoints
- Market insights and perspectives from our Asset Allocation Research Team

Access Our Specialists

- Portfolio Construction Guidance Strategists can provide you with an in-depth portfolio review to strengthen the execution of your investment strategy and consult with you on portfolio challenges.
- Dedicated specialists focused on market and industry trends related to fixed income, sector, and international disciplines can be accessed via your Fidelity representative

Working with you to bring more to your clients.

ORIGINAL INSIGHT / TAILORED ACCESS / DIVERSE INVESTMENT CAPABILITIES

institutional.fidelity.com

For investment professionals.

Not FDIC Insured • May Lose Value • No Bank Guarantee

Not NCUA or NCUSIF insured. May lose value. No credit union guarantee.

Unless otherwise disclosed to you, in providing this information, Fidelity is not undertaking to provide impartial investment advice, or to give advice in a fiduciary capacity, in connection with any investment or transaction described herein. Fiduciaries are solely responsible for exercising independent judgment in evaluating any transaction(s) and are assumed to be capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies. Fidelity has a financial interest in any transaction(s) that fiduciaries, and if applicable, their clients, may enter into involving Fidelity's products or services.

[1] Average results do not reflect every fund in every period. See Fidelity Leadership Series article, "For Active and Passive, Low-Fee Funds with Size Advantages Continue to Lead" (March 2017).

[2] Estimated net flows for calendar years. Source: Morningstar, as of of Dec. 31, 2016.

[3] Technology stocks represented 29% of the S&P 500 Index as of Dec. 31, 1999, vs. a 20-year average of 18% (1997 to 2016). Source: FactSet, as of Dec. 31, 2016.

[4] Excludes money market securities. Data as of Dec. 31, 2006, and Dec. 31, 2016. Source: Securities Industry and Financial Markets Association (SIFMA).

This information should in no way be considered investment advice. There is no guarantee the trends discussed in this piece will continue. Investment decisions should take into account the unique circumstances of the individual investor.

Stock markets, especially foreign markets, are volatile and can decline significantly in response to adverse issuer, political, regulatory, market, or economic developments.

Foreign securities are subject to interest rate, currency exchange rate, economic, and political risks.

In general the bond market is volatile, and fixed income securities carry interest rate risk. (As interest rates rise, bond prices usually fall, and vice versa. This effect is usually more pronounced for longer-term securities.) Fixed income securities also carry inflation, credit, and default risks for both issuers and counterparties.

Fidelity Investments & Pyramid Design is a registered service mark of FMR LLC. Third-party trademarks and service marks are the property of their respective owners. All other trademarks and service marks are the property of FMR LLC or an affiliated company.

Before investing in any mutual fund or exchange traded product, have your client consider its investment objectives, risks, charges, and expenses. Contact Fidelity for a prospectus, or a summary prospectus if available, containing this information. Have your client read it carefully.

818363.2.0
FIAM-BD

FIDELITY INVESTMENTS INSTITUTIONAL SERVICES COMPANY, INC., 500 SALEM STREET, SMITHFIELD, RI 02917

1.9885862.101
1017