

# Evaluating the 'activeness' of your equity portfolios

*In an environment where alpha is at a premium, it's more important than ever to know which of your funds managers are taking sufficient risks to achieve it.*

*The proliferation of 'concentrated' versions of flagship Australian and international equity funds over the last couple of years might tell you that tracking error and stock count are the best indicators of alpha potential – but as this roundtable put together by Investment & Technology and Principal Global Investors last month shows, 'concentration' does not necessarily translate as that other buzzphrase of the moment, 'high conviction'.*

Participants at the roundtable were:

- **Michael Bailey**, editor, *Investment & Technology*
- **Steven Carew**, head of investment research, JANA
- **Russell Clarke**, CIO, Mercer
- **Richard Dalidowicz**, senior investment manager, AustralianSuper
- **Tim Dunbar**, executive director – equities, Principal Global Investors
- **Kristian Fok**, deputy managing director, Frontier
- **Laurence Irlicht**, investment director – quantitative analysis, VFMC
- **Greg Liddell**, director – implemented equities, QIC
- **Mark Nebelung**, portfolio manager, Principal Global Investors
- **Amanda White**, journalist, I&T Magazine
- **David Wright**, director, Zenith Investment Partners

**Tim Dunbar:** I spend a fair bit of time in Australia talking to clients and prospective clients. We always seem to end up talking about concentrated portfolios in one way or another. I think with some of the market turmoil over the last 18 months, some of our clients have seen some of their very concentrated portfolio managers have some very difficult times. And perhaps we're seeing a little bit of interest back towards diversification. But the focus has and

always will be on alpha. Everyone wants a lot of alpha and no volatility, and a lot of risk. And of course that doesn't exist. So one of the things that we hope to get out of today is exactly what's meant by 'concentrated portfolios', as well as how you determine an active manager from more of a passive manager. What are some of the tools you can use? Mark, do you want to touch base on some of the work we've done and applied to our own portfolios and benchmarks?

**Mark Nebelung:** Historically there's been this connection that tracking error translates into how active a particular strategy is. At Principal we're fairly style neutral, so we've generally had fairly low tracking error. Yet in terms of our portfolios we've been very active. So we've been using the concept of an active share and coverage ratio. Basically looking at what proportion of our portfolio is actually overlapping the benchmark in terms of evaluating how active our portfolio is, rather than tracking error, because tracking error really doesn't capture activeness, it captures consistency or lack of consistency of your excess returns. So a manager that consistently outperforms by 10 per cent, a manager who persistently underperforms by 10 per cent or a manager that doesn't outperform at all, all have the same tracking error, of zero, because they're consistent. So you lose some of that information.

And there is another issue in terms of concentration. I've never really heard anybody have a good definition of what a concentrated portfolio is. Most of the feedback that I generally have is, you know, something with 25-50 stocks in it. But you know, in Australian equities that could easily represent 5 or 10 per cent of your investable universe.

If I look at a global portfolio, if I use that same metric of 5 or 10 per cent in the universe of 6000 securities or so, well shouldn't I be holding 600 securities for the same level of concentration? But even in that context people are still



thinking about 25-50 securities. So that's been an interesting conundrum.

**Amanda White:** Let's throw it to the table to get a few definitions of what you guys actually call concentrated portfolios.

**Russell Clarke:** It's somewhat of a theoretical construct. People would typically think, low number of securities, a reasonably large active stock position versus a benchmark.

**Laurence Irlicht:** You could, if you chose to, select 25 stocks that would probably get you a reasonably low tracking error to the Australian index, if you selected and weighted those 25 stocks appropriately. Look at your top contributors to portfolio volatility. For instance, in the Australian market a few months ago, BHP alone contributed 20 per cent of the total risk for the market. The ASX300, you've got 300 stocks - in one sense that doesn't sound concentrated, but on the other hand everybody knows the Australian market is concentrated. If you look at one stock being 20 per cent of the risk.

**Amanda White:** What about you, Steven?

**Steven Carew:** You can have a 100 or 200 stock global manager, but if they're investing very heavily in say the small cap space, or the emerging market space, that's very different to if they're just swimming in the large cap space. So it's impossible to define and you've just got to make an assessment of the overall risks, to see whether there's a concentration of risk or not.

**Michael Bailey:** Thinking about it cynically you could almost say it's somewhat marketing driven. Everyone seems to have released a concentrated version of their original portfolio, a 'best ideas' portfolio. To all of the consultants here - what sort of questions do you ask of managers who are offering a concentrated or a 'select' version of their core? Do you get them to justify why they are running two products?

**Steve Carew:** Sure. Certainly there have been cases where we would say concentrated portfolios are being launched to raise more assets, or as part of a staff retention scheme, to keep a deputy portfolio manager. And in some cases we think that can be a positive. If it's keeping the hair apparent, if you like, in the team along with the key portfolio managers. You have to try and get to the bottom of the overall situation.

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**David Wright:** I think one of the natural questions to those managers is whether they're just dialling up the active positions in their diversified portfolio, or whether they're actually starting again. There's been a number of the institutional managers, mainly, that have launched concentrated portfolios, probably three years ago now. It's been a real mixed bag - some have outperformed their diversified portfolios, others haven't.

We believe that running a concentrated portfolio is a different mind set. So the way you approach it should be quite different from the way you approach a normal diversified one.

I don't personally think it's as easy as just dialling up your active bets.

**Kristian Fok:** You've got the broad based fund which has large funds under management. And you've got the concentrated version which has actually got much lower funds under management. Often that gives the portfolio manager...forgetting about the restrictions on stocks, because if there's less funds under management, it often gives him more freedom to actually really execute. So it's not so much about conviction, but it's actually about the universe you invest in. And so sometimes you actually find, ironically, that the concentrated funds have more small cap biases at times because they can actually get into the ideas, whereas that doesn't necessarily intuitively... You know, you'd think that if you've got less stocks to pick, you're having bigger positions... but because there's less money in those funds, they're able to actually not only execute supposedly 'best ideas' but also do it efficiently.

So you really do need to look at whether it's just a subset or...and it's also the relative weightings that they put in there, and quite often you can see that there is quite a difference, especially some of the smaller cap ideas or the more liquidity constrained ideas.

**Russell Clarke:** There is a different mind set running a concentrated portfolio, and in particular it's much harder to balance the risk in a concentrated portfolio. As the number of stocks come



Tim Dunbar

down, in a sense perhaps it's easy to dial up the ideas from the core portfolio in terms of what you really have conviction in, but it's much harder to make the trade off in risk. So therefore some people are going to be able and good at doing it, whereas other managers might have thought about the marketing but not really thought about the appropriateness of running it.

**Mark Nebelung:** Can I just ask, what is the mind set of a successful concentrated portfolio manager?

**David Wright:** Personally I think it goes right to the heart of the investment process. It can start right from the initial stock screening and what are the factors that are important in that process, that then defines the universe that the manager's going to concentrate in with further research.

With a lot of the boutique Australian equity managers, I think in the main most of the ones that have generated good alpha have tended to do so reasonably early on through probably medium and small cap. And as they become institutionalised, for want of a better term, both the weight of money and I think the business risk, sort of forces them obviously to hold larger stocks and probably less active positions in those stocks.

**Kristian Fok:** People often interchange the term 'benchmark unaware' with concentrated. But that can be two very different things. There will be times when there's just too much sporadic risk, that it doesn't really make a lot of sense to force a manager down to a narrow set of ideas.

**Russell Clarke:** Financials are a great example in the current climate. The manager might hold a view that financials have been grossly oversold, and you're going to tell him he can hold only one?

**Kristian Fok:** Exactly - concentration is a nice concept but if you get too rigid about it, you can probably do more damage.

**Amanda White:** What about you, Greg, any preference for concentrated versus diversified managers?

**Greg Liddell:** We manage risk at the aggregate portfolio level, so most managers we use are concentrated in one way or another, with the exception of the quants where it's a matter of releasing the short constraint, because of course concentration of quant strategies doesn't make sense. The consequence of that is you've got to be prepared for individual managers to tread on landmines from time to time.



Greg Liddell

**Tim Dunbar:** Are your clients willing to accept that kind of volatility?

**Steven Carew:** One of the things we've found is putting a group of concentrated managers together doesn't mean that you get a higher tracking error portfolio. You can still end up with a relatively low tracking error, but you've increased your stock selection risk. If you haven't chosen the right managers you can get a worse result than picking a group of core managers. And I think one thing that's been exposed with con-

centrated managers is that this reaching for risk, in the low volatility environment that we've seen until recently, has come back to bite a few people because they didn't understand perhaps as well as they should what they were doing with their portfolios.

**Mark Nebelung:** You need to decompose whether your managers are macro tilters or stockpickers, and I think a lot of concentrated managers fall somewhere in between.

**Richard Dalidowicz:** There's been examples in Australian equities of managers I know really well who have run 25 stocks where 23 stocks have done really well, but the two or three that didn't have just blown them out of the water.

**Tim Dunbar:** So what's driving the interest in concentrated portfolios? One is the desire for alpha, so the belief that these particular managers know what they're doing, and their investment process can out perform the benchmark, right? And for multimangers, it's putting those different managers together in a way that makes sense from an over-riding asset allocation perspective.

**Michael Bailey:** I'd like to ask the portfolio constructors here whether they've gone through a similar exercise to what Principal's done in the paper you received by their global CIO, Mustafa Sagun. They compared a global equity portfolio comprised of eight of their products - the full range from US core, growth, value and small cap to the same in international - to a global equity portfolio consisting of their Global Core fund alone. And they found the Global Core provided about half the coverage ratio - so more active - for about 25 per cent less fees. Richard, I know AustralianSuper has about 15 international equity managers - dare I say it, have you ever compared that portfolio on an after-tax, after-fees basis to, say, a single enhanced passive manager?

**Richard Dalidowicz:** Of course. We're aware that the risks we take can actually be offsetting. But we focus

more on juicing up the return, not the risk aspects. The risk is just a backward looking thing. You know, it's an indicator, sure. It gives you an idea about whether managers are true to label. But the challenge is to look forward. The question I'd like to ask is that in today's narrow market environment, there's only two sectors that are doing really well - materials and energy. And in this environment do you guys think, on average say, a concentrated manager would perform better than a broad manager. Say one holding 30 stocks versus 200?

**Laurence Irlicht:** Any manager that happens to have been holding materials and energy, regardless of whether they're concentrated or not, they're going to have been doing well. And if they happen to be holding financials and property trusts - not so well recently.



Kristian Fok

**Kristian Fok:** I think the analysis of just putting value and growth together is too simplistic. In this environment, there's probably been other decisions like resources and financials. Even though you think it cancels out, it's amazing the number of times you get a growth manager and a value manager and they talk about the same stocks, both holding them but for their own reasons. Granted, there are times when you want to have a growth manager that's not investing in financials and a value manager's starting to get in. But to think of value and growth as mutually exclusive I think is a bit wrong. There is a lot of overlap. So there is benefit in having the two styles.



Russell Clarke

**Russell Clarke:** A question worth honing in on - should you use deep style managers in a concentrated sense, because typically a deeper style manager will be more concentrated by their nature. And that is a very different animal to a more style agnostic manager that then might run a concentrated portfolio. It's probably worth getting people's thoughts just on how they view those different types of managers because you can build very different portfolios.

**Steve Carew:** I think the answer to that is that if you have a deep value manager or a deep growth manager then you look to your appropriate benchmark and see if there's alpha there. You don't benchmark them against a style neutral benchmark and argue that a risk premium is in fact an alpha.

**Russell Clarke:** What if you do use managers who are very concentrated and they do underperform significantly, perhaps on a broad benchmark rather than a style-based benchmark. Because that is a real problem in the real world. Theoretically you should take the really highly style-tilted managers and throw them together in a portfolio and get a style neutral portfolio, hopefully with lots of alpha. In the real world that never happens. And the risk is that somewhere down the fiduciary chain - the management team, the investment committee or the board will be saying, "What, we've got those guys? They're 20 per cent under benchmark!" And they'll want to fire that manager and keep the managers who are doing well, whereas they should be doing the exact opposite. But it's a really, really difficult thing to do. We're not a big fan of deep

style managers, precisely because of that fiduciary conundrum.

**Tim Dunbar:** Has that changed? Have clients gotten more sophisticated in looking at longer term returns and having patience with those kinds of managers?

**Kristian Fok:** Everyone's sophisticated when it's working! The trick is to be very clear about how and why a manager gets put into the portfolio. On the international front, you've actually had this flipping of value and growth over the last little bit of time and it's actually been quite good because you can go back to the last year's report and say, "Well, these were the worst performing managers and this year, they're the best performing." So on the international front you've been able to sort of manage the risk of a knee-jerk reaction to a period of negative returns, on the Australian front, that's been a bit different because up until recently there was more of a growth favour.

**Russell Clarke:** It's a very difficult thing to go to any sort of fiduciary and say, "Hey they're our best performing manager and we think they should be fired." Unless they've actually got a clear breach of risk.



Richard Dalidowicz

**Richard Dalidowicz:** Depending on your cashflows you might be able to call it aggressive rebalancing.

**Kristian Fok:** What seems to work reasonably well for us is you get your trustees to think about the invest-

ment environment separately from the manager: what do you think's going to happen? Where do you think the risks are? And then you get the manager in to state what their view is and why - and then you can really say, "Look, they're fundamentally different to the way that you think the environment's going to pan out. Do you want to continue with such a large allocation?"

**Steven Carew:** You've got to be constantly evaluating managers as to the reason why you appointed them in the first place and we've recommended, sometimes successfully, termination of outperforming managers because at the end of the day your manager has to be following its stated investment process and style, have the capable people to execute that, have all the organisational factors, remuneration structure, the situation with the parent, all those sort of factors come into account and usually when we advise a termination of a manager it's because there's something wrong on the organisation or the qualitative side, it's not to do with the fact that style has drifted or the fact that we're taking a big punt that value's going to out-perform next year. Fortunately, clients like AustralianSuper have hundreds of millions of dollars going in the door every year, which does allow you to rebalance a portfolio with cash flows and so you think, well, value looks expensive, I'm not going to get rid of all my value but I'm going to focus more on growth or emerging markets or just 'cheap' or whatever it is and so, to us, whether a manager's out- or underperforming is not really the question. It is, are they doing the job that you put them in there to do? Do they have the capability to continue to do what you put them there for in the first place.

**Mark Nebelung:** I've got to confess we've never been fired for outperforming.

**Amanda White:** Welcome to Australia! ■