







# The Benefits of a High Conviction Approach

PortfolioConstruction Conference 2006

*“Wide diversification is only required  
when investors do not understand what  
they are doing.”*

Warren Buffett

# Outline

-  Why now?
-  What is high conviction?
-  The Evidence
-  Successful Implementation

# Why now?

## Some definitions

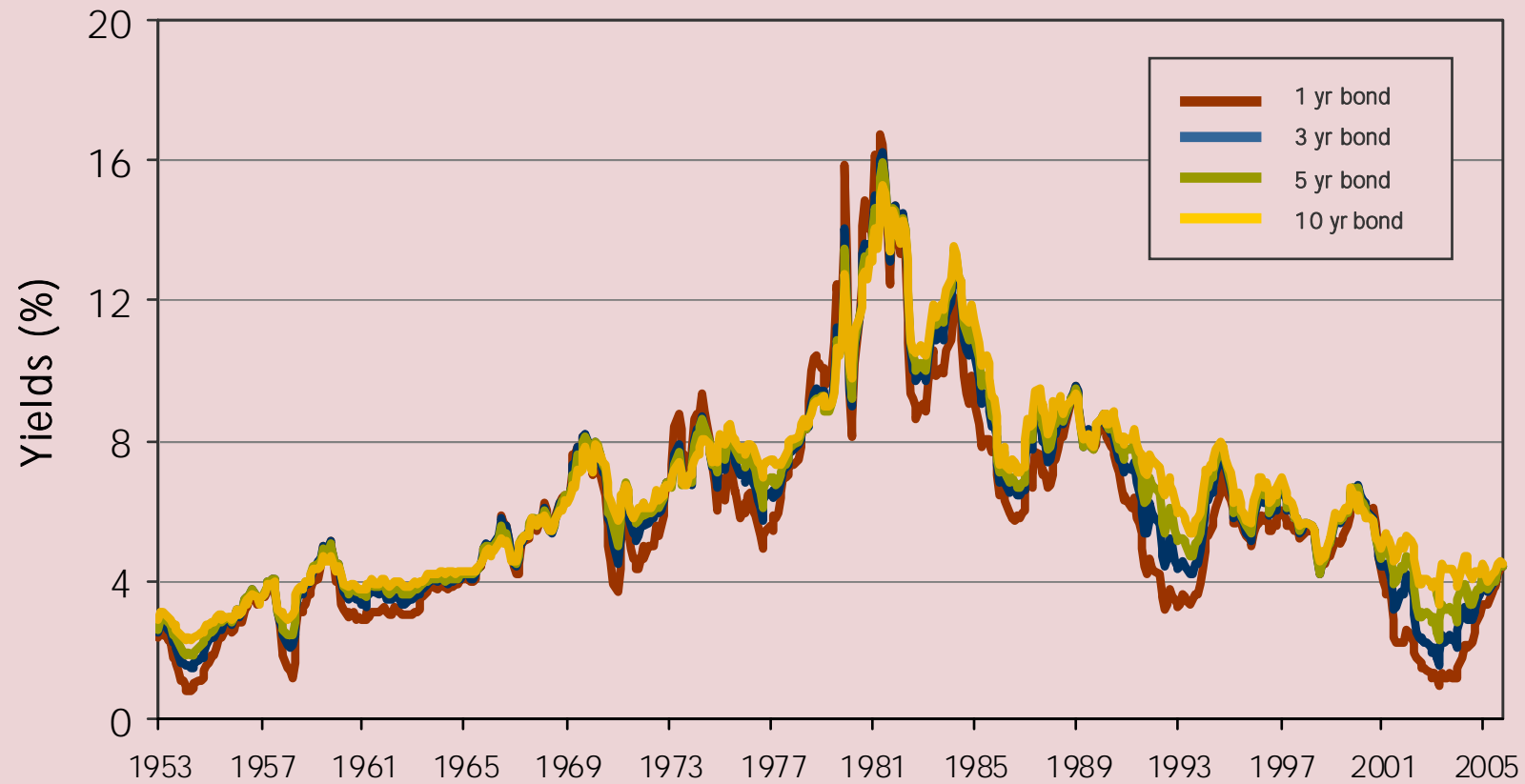
- Alpha ( $\alpha$ )  
What you should pay for
- Beta ( $\beta$ )  
What you shouldn't

# How our expectations have changed

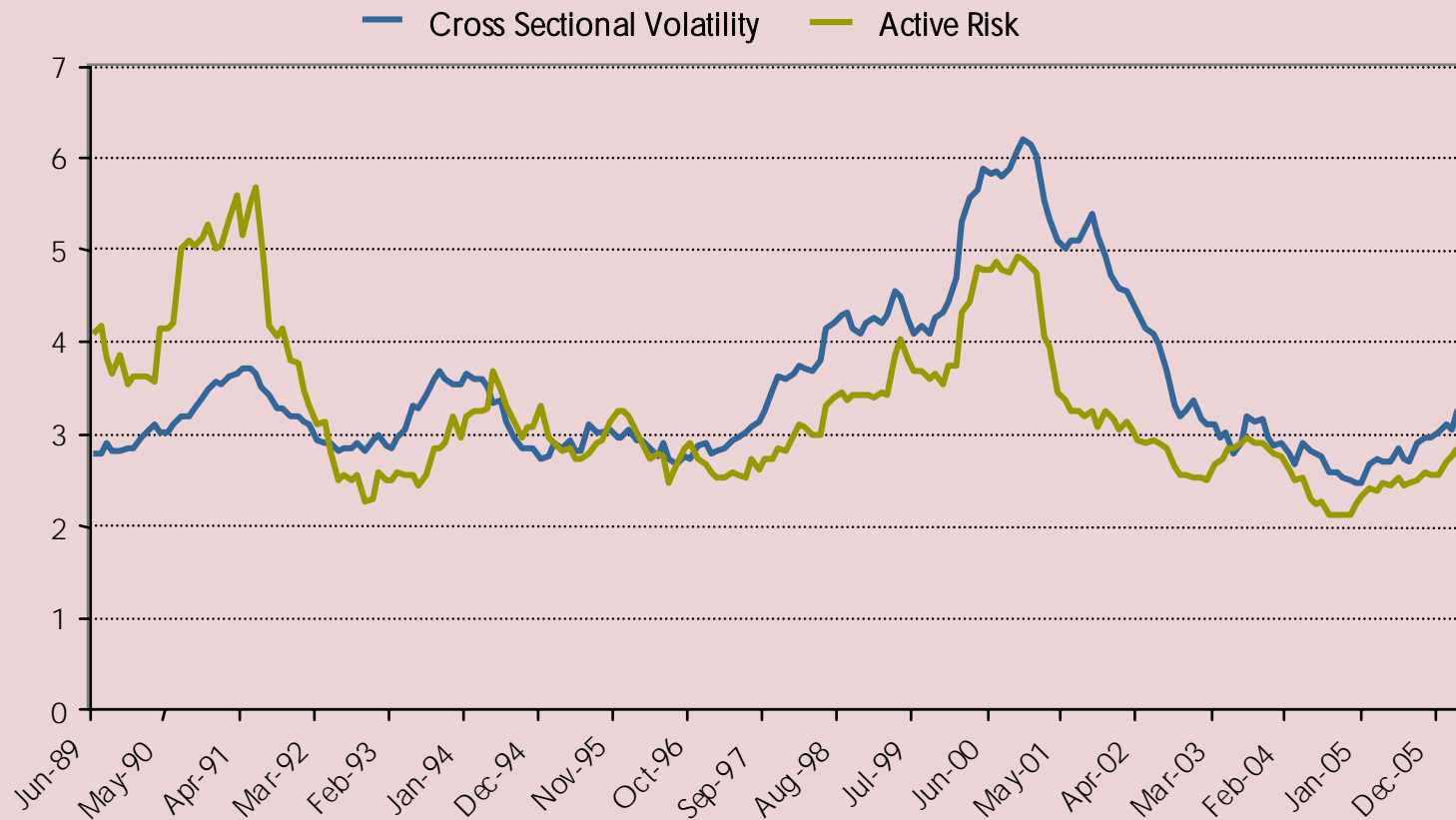
- High returns over the past 20 years driven by:
  - Attractive starting valuations
  - The shift to low inflation
  - Deregulation policies
  - Wealth accumulation by baby boomers
- Asset class returns likely to be single digit going forward

# The market tailwind has slowed

## Term to Maturity Yields

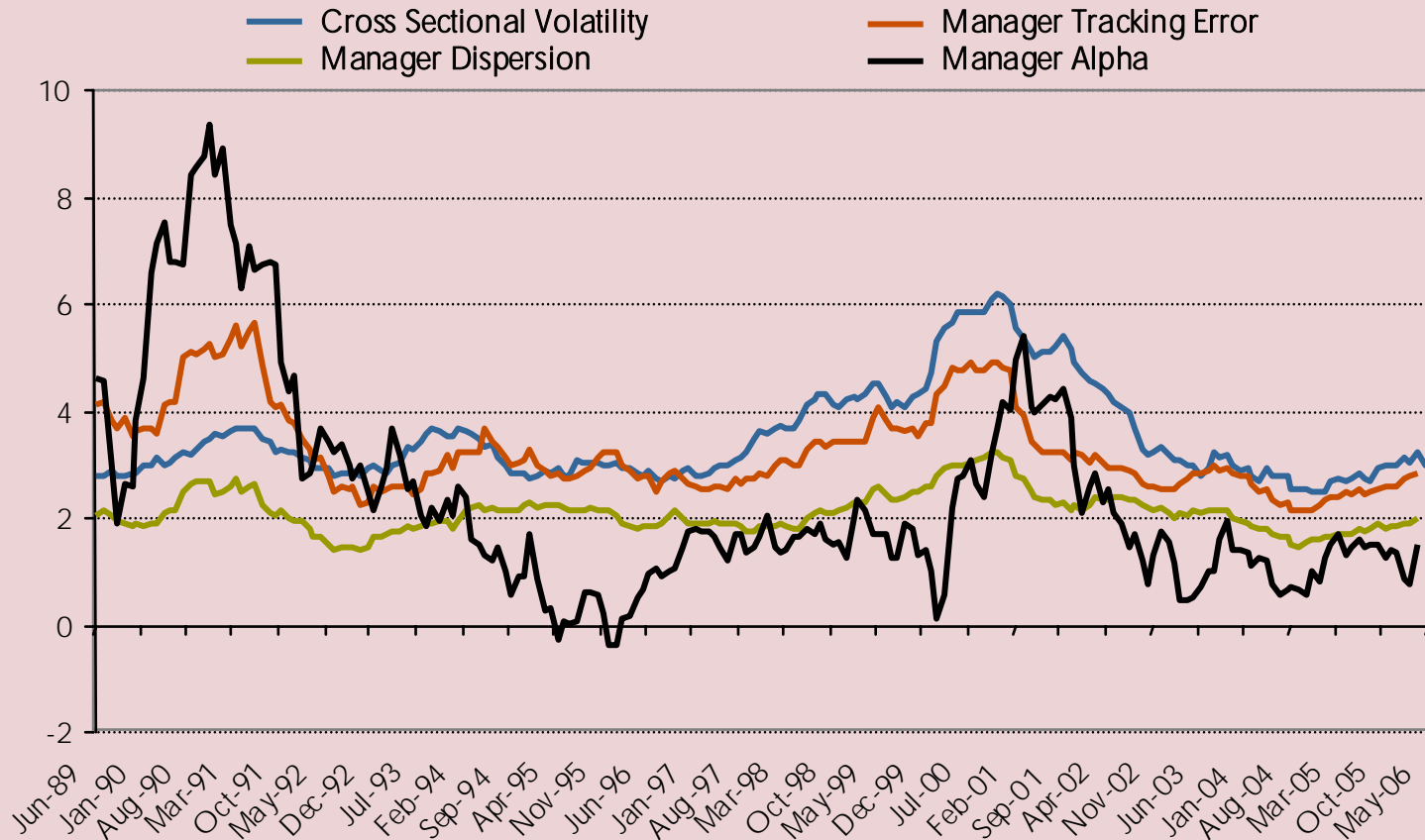


# Alpha opportunity set is changing



Sources: Russell Investment Group, Bloomberg

# Alpha opportunity set is changing



Sources: Russell Investment Group, Bloomberg

What is high conviction?

## High Conviction Funds: Definition

- Fewer Stocks
- Higher Risk

$$DI = \sum_{n=1}^N (w_n - w_n^b)^2$$

# The Evidence

# Some examples of managers offering high conviction funds

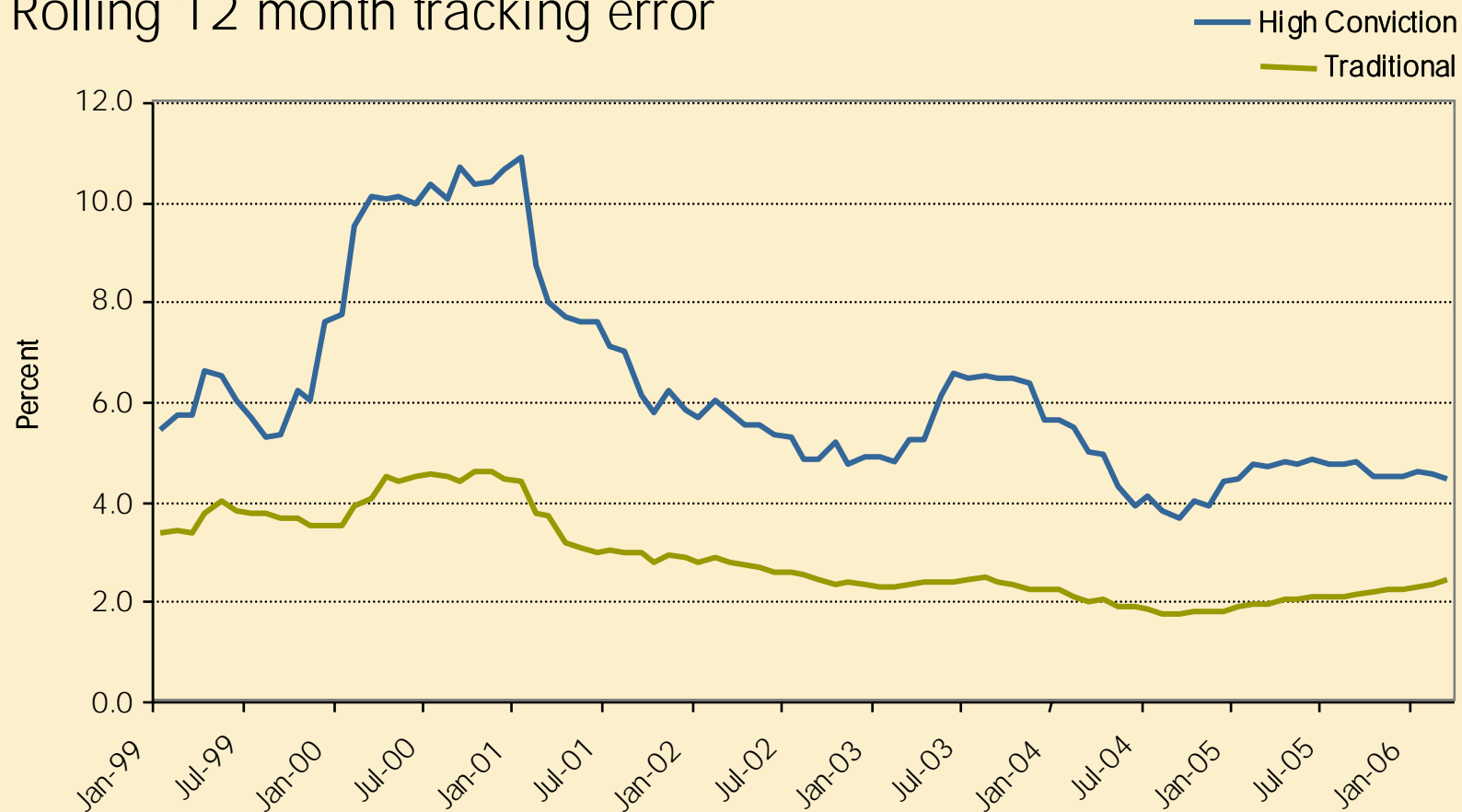
- BT
- 452 Capital
- Challenger
- Lazard
- ABN Amro
- MIR
- Quest
- Russell Select Holdings
- Russell Australian Opportunities Fund

# Characteristics of Aust Equity Managers

	High Conviction	Traditional	All
# Managers	18	54	72
# Boutiques	12 (67%)	16 (30%)	28 (39%)
Avg Stock Level <i>DI</i>	4.2%	1.2%	1.9%
Avg Sector Level <i>DI</i>	5.0%	1.6%	2.4%
Avg # stocks	41	81	71
Avg Perf History	3.4 years	9.3 years	7.8 years

# High Conviction managers (surprise surprise) take more risk

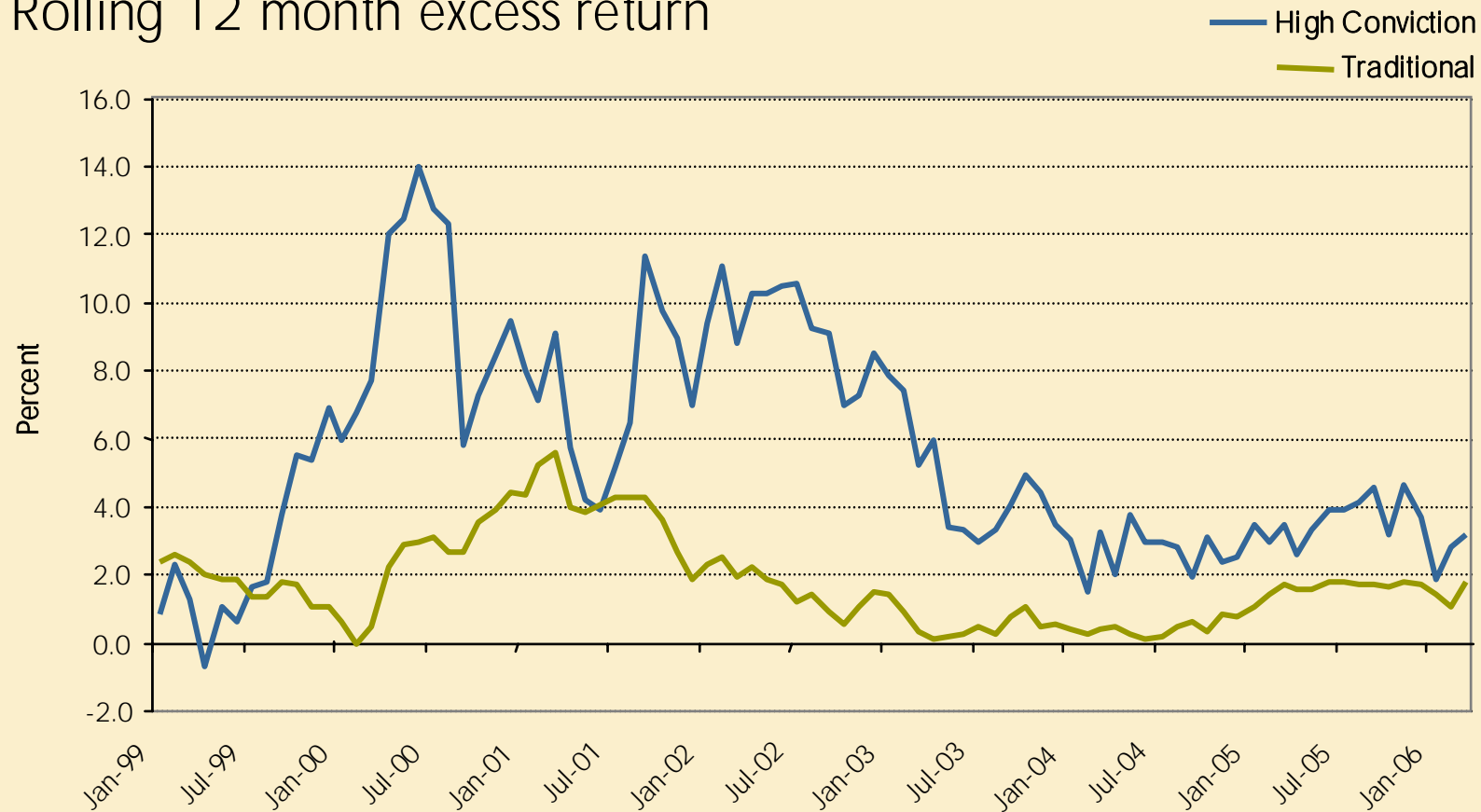
Rolling 12 month tracking error



Source: Russell Investment Group

# And this risk has paid off

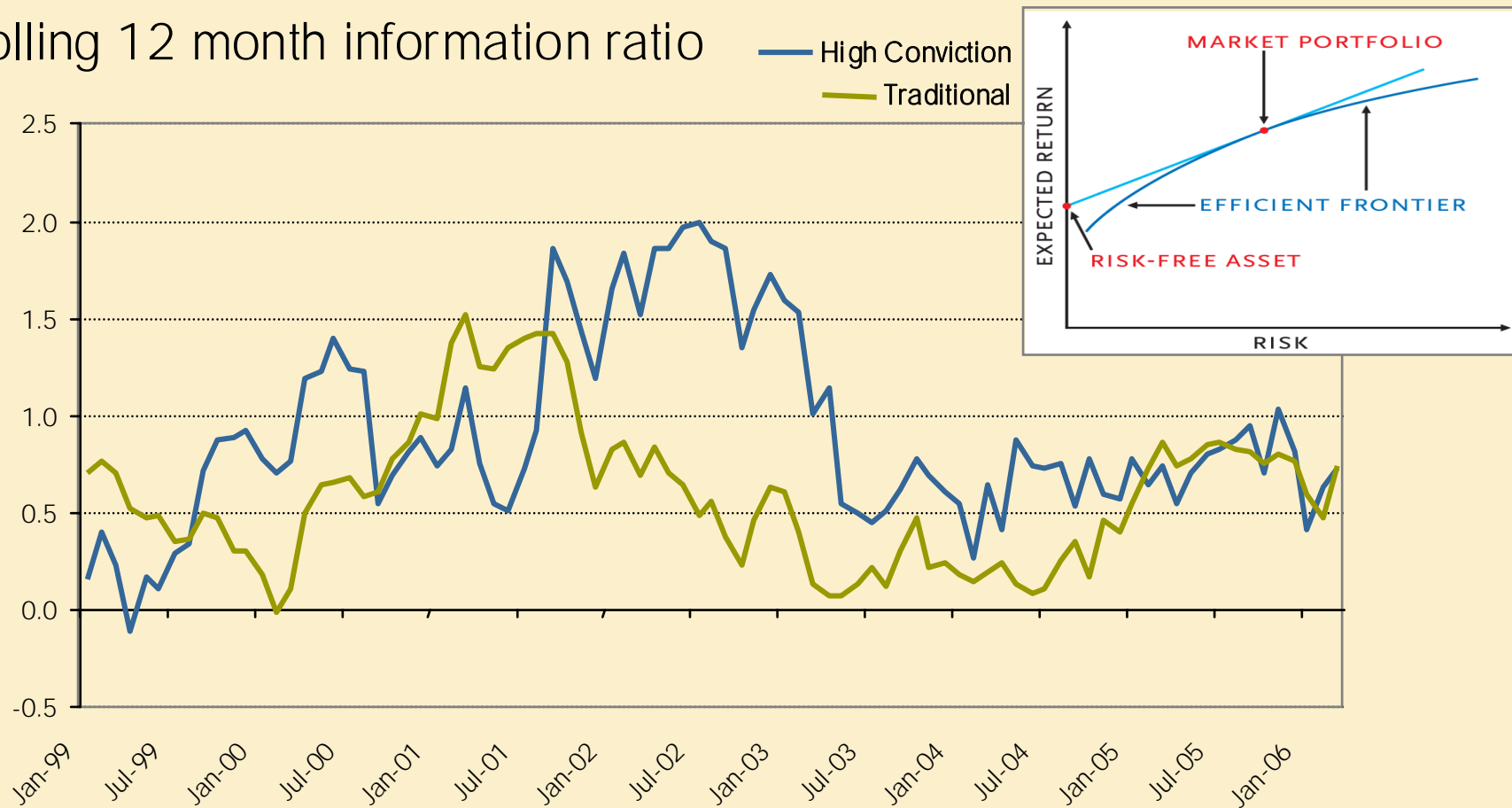
## Rolling 12 month excess return



Source: Russell Investment Group

# The rewards have tended to outweigh the risks

Rolling 12 month information ratio



Source: Russell Investment Group



# Successful Implementation

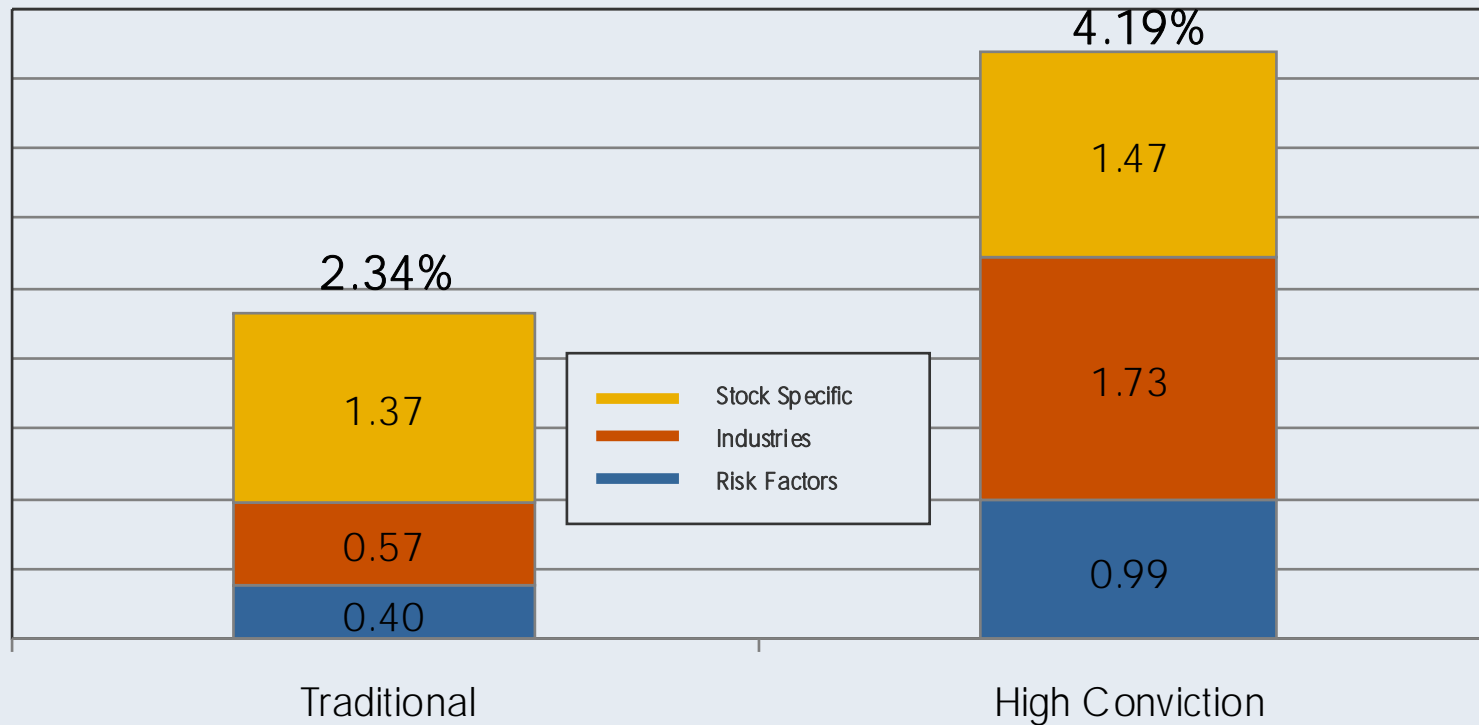
# Portfolio construction issues

- Alpha cannot be diversified away...
- but choosing the wrong managers can be costly
  - 21.5% differential between best and worst high conviction managers over the last year!
- The 'boutique effect' – need to identify good managers early
- Solid manager research and selection is essential

# Not all risks are created equal...

## Single manager

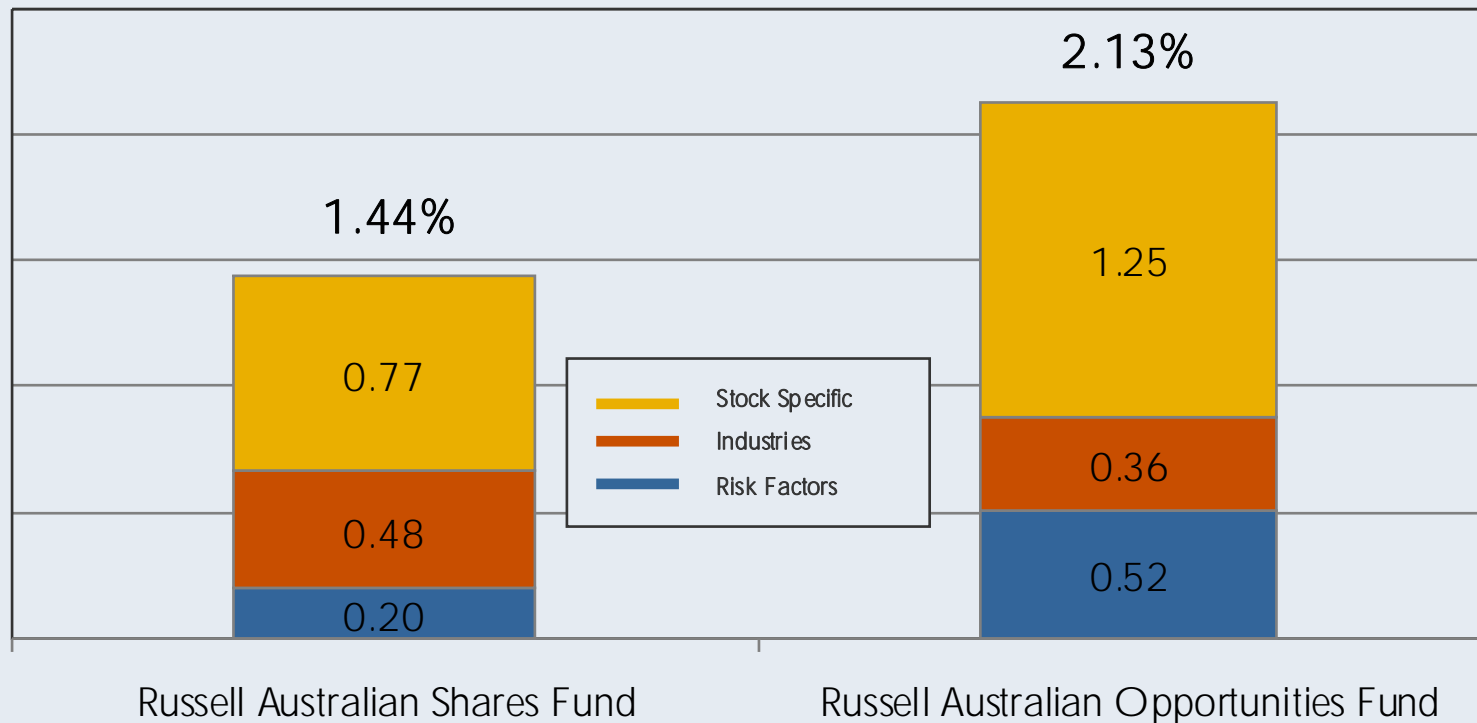
Representative high conviction & traditional managers:  
Decomposition of Tracking Error (% p.a.)



Portfolio shown as at 30 June 2006 Source: BARRA, Russell Investment Group

# Choosing the risks you want... Multi-Manager

## Russell Multi-Manager Funds: Decomposition of Tracking Error (% p.a.)

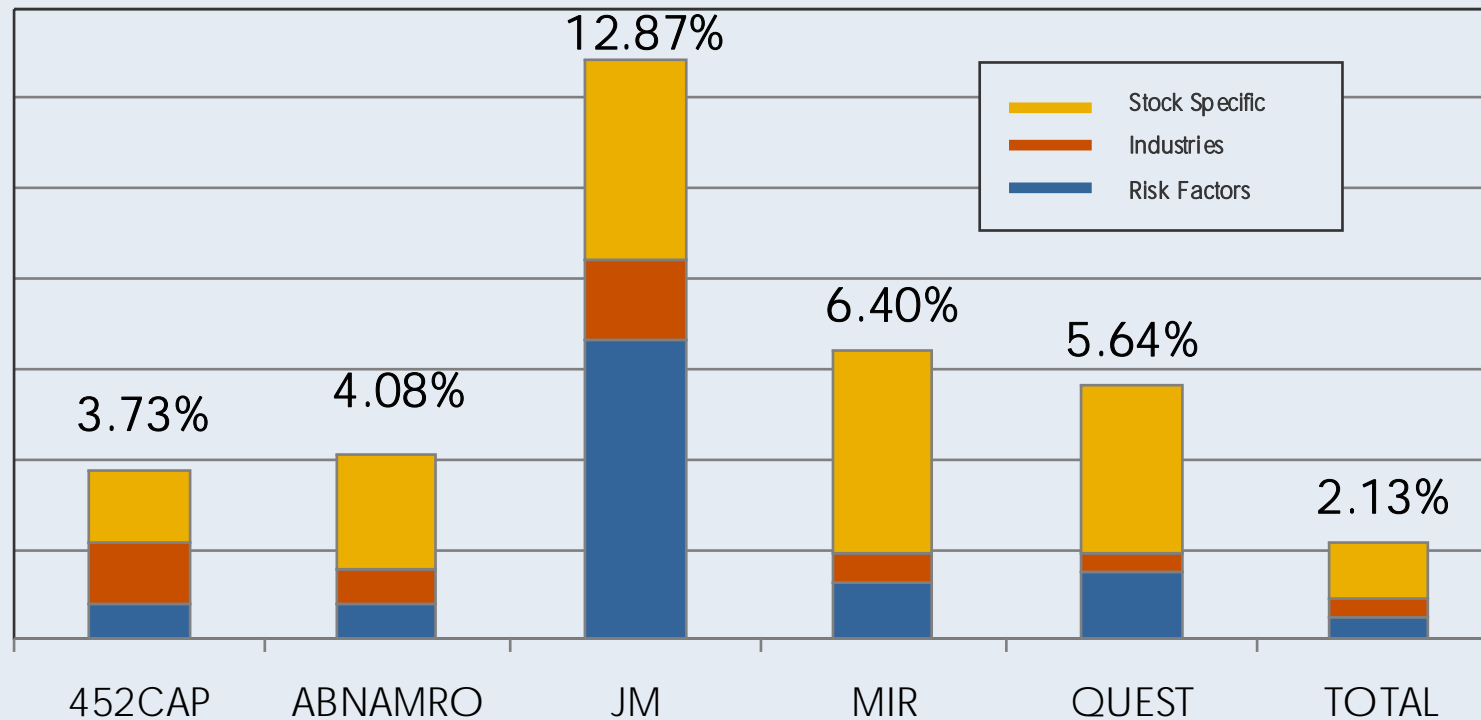


Portfolio shown as at 30 June 2006 Source: BARRA, Russell Investment Group

# Decomposition of risk: Russell Australian Shares Opportunity Fund

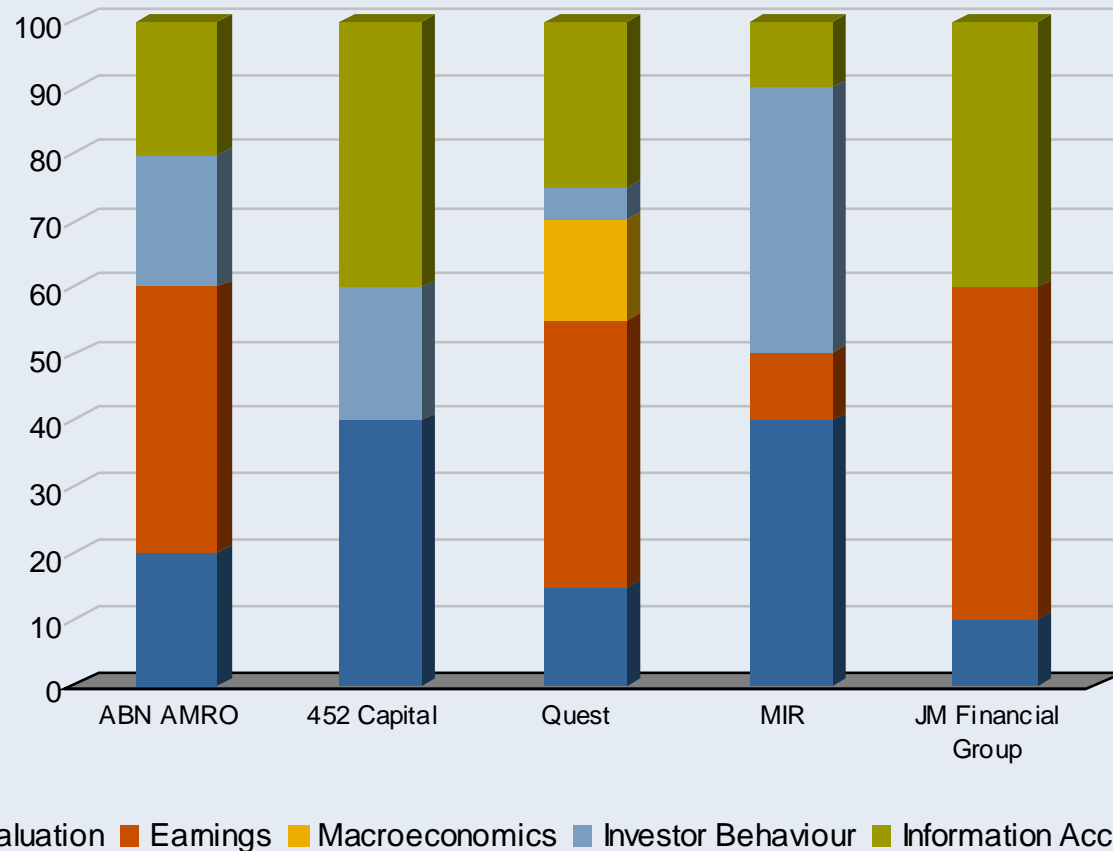
Sources of Risk:

Decomposition of Tracking Error (% p.a.)



Portfolio shown as at 30 June 2006 Source: BARRA, Russell Investment Group

# Australian Shares Opportunities Fund Process Diversification



Source: Russell Analysis

# The bottom line

- High conviction investing has merit
- Best implementation is via a “skilled” multi-manager
  - Can’t have too much of a good thing...or can you?
- The right allocation depends on risk tolerances



[www.russell.com.au](http://www.russell.com.au)

- 1936** Tacoma, Headquarters
- 1969** New York
- 1979** London
- 1984** Toronto
- 1986** Sydney
- 1986** Tokyo
- 1991** Auckland
- 1994** Paris
- 1999** Singapore
- 2004** Melbourne