

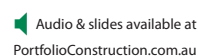
RESEARCH PAPER

PRODUCTS
(TAKING STOCK)

A high conviction approach to Australian equities

By Peter Gunning, CIO, Russell Investment Group

A large number of high conviction or “concentrated” equity funds have been released in recent years, all promising higher returns than traditional funds by focusing on the strongest stock selection ideas of a manager. This paper examines the evolution of high conviction funds, looking at why they have been developed, their risk/return characteristics and the broader implications for portfolio management. High conviction funds have posted higher returns than traditional funds, but the wide dispersion between the returns of different funds means that manager selection and evaluation is critically important. A solution is to gain high conviction exposure through a multi-manager structure. This approach harnesses the manager selection skills of multi-managers and minimises the risk that individual style, sector or manager performance will dominate overall investment performance.



Fund managers have been queuing up in recent years to release high conviction or concentrated equity funds. This idea is not new – absolute return strategies have been around for a long time. The recent proliferation of these funds has been driven by the same forces that have generated new investment strategies across a range of asset classes – the decline in long-term expected returns and cross-sectional volatility. These forces have seen investors explicitly separate alpha from beta, and have led fund managers to develop products that focus on alpha generation.

High conviction investing typically means holding fewer stocks and taking larger positions relative to the benchmark than traditional funds. The intuitive appeal is that managers are freed to focus on the stocks and sectors in which they have the most expertise and do not have to spend effort managing benchmark holdings in low conviction stocks.

However, the potential for higher above benchmark returns comes with added risks. Manager selection becomes more important in a high conviction context, as the exposure to style, process and skill differences between managers is amplified. Choosing a manager with poor skill or an out of favour investment style can prove costly. One way to minimise these risks is to invest in a multi-manager fund.

A common approach for investors and those who advise them is to individually select a combination of different fund managers. Outsourcing this aspect of portfolio construction to a multi-manager has a number of benefits. Multi-manager fund managers specialise in evaluating fund managers and in blending different manager styles into a single investment product. This approach to high conviction investing combines skill in manager selection with the benefits of manager diversification to help control style bias. Using a multi-manager also shifts the costs associated with constant monitoring of fund managers, often a significant burden. Investors take the risks they want – exposure to the best stock selection ideas of professional money managers – while minimising risks they don't want – the risk of choosing a poor manager or investing in a style that is temporarily out of favour.

Why high conviction?

Low expected asset class returns – the increasing importance of alpha and commoditisation of beta

For some years, market analysts have warned investors to prepare for lower returns from asset classes than they have enjoyed in the past. For example, Oliver (2005) argues that the high return drivers of the 1980s and 1990s have largely run their course. These high return drivers included attractive starting valuations, the move from high to low inflation, deregulation policies, the wealth accumulation phase of the baby boom generation, and the peace dividend from the end of the Cold War. Investors have been told to anticipate high single digit equity returns going forward.

The outlook for lower asset class returns has made investors focus more heavily on the ability of managers to generate returns in excess of the benchmark (alpha). Individual manager performance tends to take a back-seat when the overall market returns 20% per year or more. However, the extra return delivered by managers in the form of alpha becomes more important when the overall equity market seems likely to deliver average annual returns of around 7% to 9%.

Commoditisation of beta is another factor driving investment managers to portray themselves as alpha generators. The abundance of cheap index funds and the depth of futures markets mean investment managers can no longer charge high fees for delivering close to benchmark returns. The ability to deliver alpha will be integral to their ongoing viability. In the pursuit for higher alpha, traditional funds management constraints may be lifted. One such constraint is the long-only constraint. Others include diversification limits and benchmark relative risk. This paper focuses on the last two constraints by examining long-only, high conviction portfolios.

In pursuit of alpha

Not only has alpha become more important, it has become elusive. The more investors trawl global markets seeking excess returns, the more efficient markets will become, making alpha more difficult to extract.



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The level of dispersion in individual stock and sector returns is another important determinant of alpha opportunities. When stock or sector dispersion is high, skilful managers can add value by selecting stocks or sectors with the best performance and avoiding those with the worst. When dispersion is low, however, there will be few opportunities for skilful managers to shine (since the best stock selections will not outperform the average by as much). The most common measure of dispersion in stock or sector returns is cross-sectional volatility (xsv), which is defined as:

$$xsv_t = \sqrt{\sum_{n=1}^N w_{n,t-1} (r_{n,t} - R_t)^2}$$

where:

$w_{n,t-1}$ denotes the benchmark (in this case S&P/ASX 300 Index) weight of stock/sector n in period $t-1$ ($n = 1, 2, \dots, N$);

$r_{n,t}$ is the return of stock/sector n in period t ; and,

R_t is the benchmark return.

In words, cross-sectional volatility measures the standard deviation of individual stock or sector returns around the benchmark return.

Other research studies have documented a strong positive relationship between cross-sectional volatility and three important concepts in investment manager performance: alpha; tracking error; and, performance dispersion among managers (Lundy and Gunning (2001) and Ankrim and Ding (2001)). Figure 1 shows the rolling twelve-month average sector level cross-sectional volatility plotted against rolling twelve-month averages of manager dispersion (90th percentile minus 10th percentile), average manager tracking error, and average manager alpha. When cross-sectional volatility is high, investment managers, on average, tend to perform well but with high levels of volatility. High

levels of cross-sectional volatility are also associated with large performance dispersion between the best and worst performing managers.

Just as the prospect of low asset class returns explains why fund managers are being forced to focus on alpha generation, current low levels of cross-sectional volatility help explain why a high conviction approach is being adopted by so many managers to generate the alpha demanded by investors. Managers are increasingly taking more risk and becoming less benchmark focused in the pursuit of alpha. This increased risk is no where more evident than in the recent proliferation of long-short, concentrated, absolute return and benchmark unaware funds. All are simply variants of what is here termed high conviction.

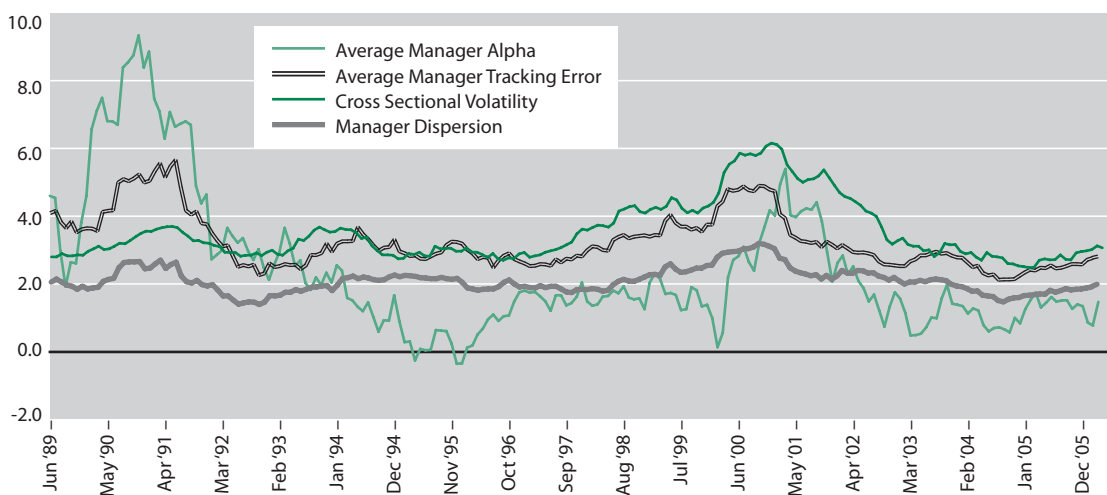
In support of high conviction

The intuitive appeal of hiring high conviction investment managers is simple. Portfolio managers with genuine skill should be allowed to focus on their best stock ideas and use this skill to enhance returns with as few constraints as possible. It makes sense that portfolio managers should focus on the areas of the market in which they have the greatest information advantage, rather than managing risks and holding stocks in which they have little conviction.

Academic literature

A growing body of empirical evidence supports the use of high conviction approaches. Two recent examples are Kacperczyk, Sialm, and Zheng (2005) and Brands, Brown, and Gallagher (2004). Kacperczyk et al. analyse a database of US mutual funds and find that more concentrated funds perform better after controlling for risk and style differences. Using a virtually identical approach, Brands et al. arrive at similar conclusions using Australian data. These studies focus on risk-adjusted returns and the results are robust to the choice of method used to compute performance and concentration.

Figure 1: Cross sectional volatility and its impact on manager dispersion, tracking error and alpha



Source: Russell Investment Group, Bloomberg

Empirical evidence

Russell Investment Group maintains a database of the portfolio holdings and performance of Australian equity managers. This database can be used to demonstrate the performance benefits delivered by high conviction equity managers. First, portfolio holdings are analysed to determine which managers can be classified as high conviction. The performance and risk characteristics of the high conviction group are then compared to more traditional, diversified managers.

The same measure of concentration developed in Kacperczyk et al and Brands et al is used to determine which managers can be classified as high conviction. This measure, known as the Divergence Index (*DI*), measures the extent to which investment managers deviate from their benchmarks. The *DI* is defined as:

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

where:

w_n is the portfolio weight in stock/sector n

w_n^b is the benchmark (S&P/ASX 300 Index) weight in stock/sector n

The *DI* based on stock weights was computed for each manager, using December 2005 portfolio holdings. Those managers in the top quartile by *DI* are classified as high conviction, those in the lower three quartiles are classified as traditional. Figure 2 describes the characteristics of these two groups.

The main characteristics of Australian high conviction equity managers are:

- shorter performance histories than traditional managers (consistent with the recent proliferation of high conviction funds);
- a high proportion of boutique fund managers (managers where key investment staff have a meaningful ownership stake in the firm); and,
- fewer stocks and larger benchmark-relative sector bets compared to traditional funds.

By definition, high conviction managers should display higher tracking errors than their traditional counterparts. Figure 3 shows the average twelve month rolling tracking errors of the two groups of managers.

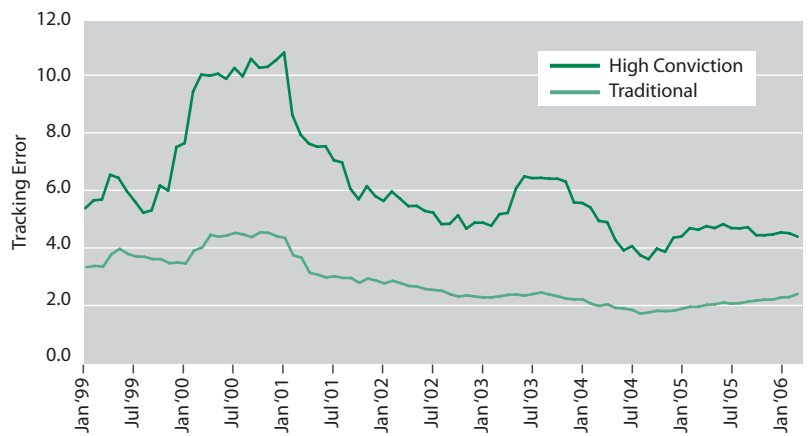
The key issue is whether high conviction managers achieve higher returns to compensate for the greater tracking error. High conviction managers will only obtain compensating return levels if they are able to succeed with their stock selection choices. Figure 4 shows that high conviction managers exhibit significantly higher returns than traditional managers. Further, they have done so in a relatively risk-controlled fashion, generally reporting higher or similar information ratios compared to traditional managers.

Figure 2: Characteristics of Australian 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 yrs	9.3 yrs	7.8 yrs

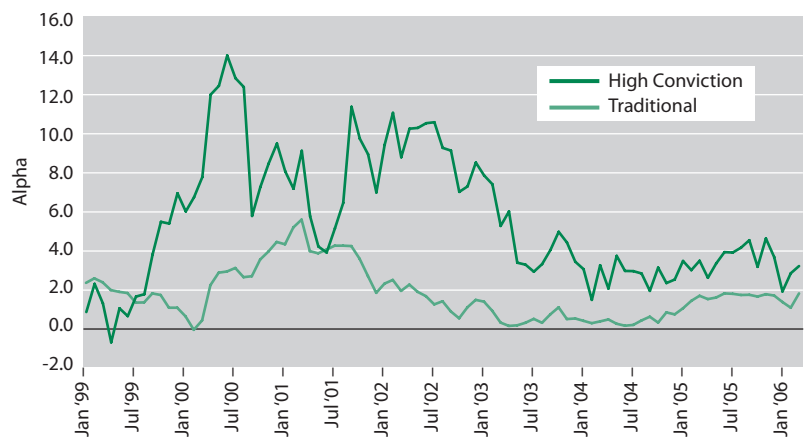
Source: Russell Investment Group

Figure 3: Rolling twelve-month average tracking errors



Source: Russell Investment Group

Figure 4: Rolling twelve-month average alphas



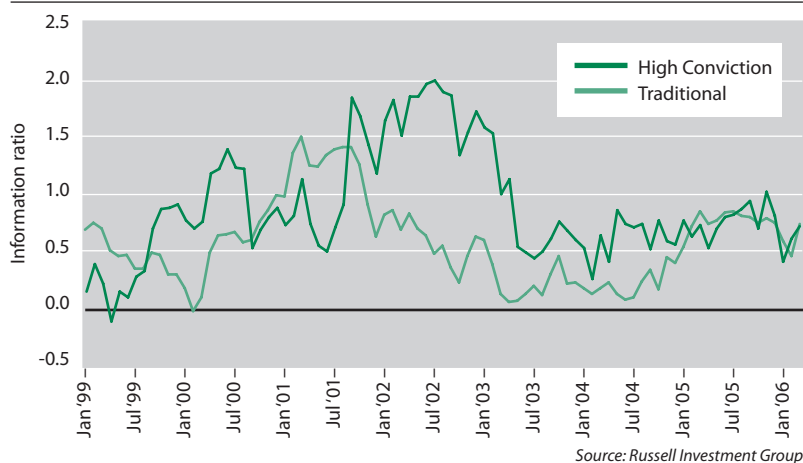
Source: Russell Investment Group

Alternative explanations

The short performance history for most high conviction managers (only two have performance histories starting before December 2002) means the results should be treated cautiously. Even so, the results support the view that high conviction equity managers, on average, produce higher returns without proportionately higher risk than more diversified traditional funds.

Why do high conviction managers achieve higher returns and information ratios (Figure 5 overpage) than traditional, more diversified managers? One

Figure 5: Rolling twelve-month information ratios



reason is that high conviction managers may simply display more skill in stock selection. Other possible explanations are:

- **shorter performance histories** – the well documented boutique effect suggests that new funds management operations deliver strong performance early on as the manager attempts to create a performance track record (Greenwood (1999)). For example, for the high conviction group of managers, the average level of outperformance in their first year after inception is 8.5%, while in years two and three, average alpha declines to 5.9% and 2.8% respectively.
- **Lower levels of funds under management** – numerous studies have found that performance is inversely related to funds under management (Christopherson, Ding and Greenwood (2002) and Chen, Hong, Huang, and Kubik (2004)). Since most high conviction funds are relatively new, low levels of funds under management may help explain their strong performance.

Ultimately, high conviction funds have performed better than their diversified counterparts. Given the same level of manager skill, a high conviction approach should generate higher returns than a typical, over-diversified, benchmark sensitive manager. Further, identifying good managers early may enhance these benefits by exploiting the solid performance often achieved in the early years after inception.

Portfolio management issues

The available evidence suggests that high conviction funds provide higher returns than traditional diversified funds. However, the decision to invest with a high conviction equity manager creates additional portfolio management issues. Foremost amongst these is the added burden and importance of manager selection and monitoring. Although the average high conviction manager has done very well, investors in the poorer performing high conviction funds have done extremely

poorly. For example, in the year to 31 March 2006, the difference in returns between the best and the worst high conviction managers was 21.5%. Investors face heavy penalties for poor manager selection.

Investors need to constantly evaluate whether the manager has moved past the high return boutique stage of its operation, as this may be a significant factor in relative manager performance. Investors also need to be aware of the influence that style bias can have on the performance of a high conviction manager. An investor will gain little comfort from investing with a high conviction manager skilled at selecting stocks with value characteristics if the market is rewarding stocks with growth characteristics.

A rise in cross sectional volatility from the current low levels would make the issue of performance dispersion even more important. Recall from Figure 1 that as cross sectional volatility increases, so too does manager tracking error and manager dispersion. This will be especially felt by high conviction approaches that are not highly diversified across all sectors of the equity market.

While higher tracking errors are guaranteed when managers adopt a high conviction approach, higher returns are not. Higher returns will only materialise if the manager possesses skill. Thus, quality manager research is essential if investors are to avoid the downside associated with misplaced conviction in a high conviction manager. A solution is to invest through a multi-manager fund that has specialist skills in manager selection. This approach can result in lower overall tracking error without sacrificing excess return potential, as shown below.

A multiple manager approach

A multiple manager approach through a fund-of-funds structure can help obtain upside potential while limiting the downside from investing in high conviction funds. Multi-managers achieve this through:

- experience in manager research to screen out low skill high conviction managers and continuously monitor the manager line-up; and,
- carefully blending high conviction managers with different styles, habitats and investment approaches.

Multiple managers reduce risk, not returns

One common misconception is that a multi-manager approach defeats the purpose of high conviction investing. Doesn't investing in a selection of high conviction managers simply result in a diversified multi-stock portfolio with lower expected returns than a single high conviction manager? An axiom of standard finance theory, however, is that it is impossible to diversify away excess returns. Combining two or more managers with positive expected alphas reduces tracking error (assuming the managers are not perfectly correlated) but cannot reduce expected

alpha. What can diminish excess returns, however, is choosing unskilled managers. A multi-manager approach minimises this risk in two ways. First, a multi-manager should have strong abilities in manager selection. Second, with a multi-manager approach, a poorly performing manager will represent, say, 20% of the portfolio rather than 100%.

Choosing the risks you want

A multiple manager approach not only reduces risk, but can also allow for the careful choice of which types of risks to avoid and which to exploit. The primary rationale for choosing a high conviction manager is that it has some skill in stock selection and, if allowed to focus attention on their highest conviction ideas, will generate higher returns than a more diversified approach. Unfortunately, a high conviction approach to stock selection often results in unwanted factor and sector biases (for example, a small-cap or growth bias, or a significant underweight to the resource sector). A carefully constructed multiple manager structure allows for the stock selection skills of different managers to shine through without returns being swamped by large factor and sector tilts.¹

Figure 2 shows that the sector level divergence index (*DI*) for high conviction managers is over three times larger than the sector level divergence of diversified managers – that is, the high conviction managers are taking substantially larger sector bets than their traditional counterparts. Such large sector bets can have a swamping impact on performance. For example, one of the worst performing high conviction managers over the past year (underperforming by almost 10%) had the third highest sector level divergence index. This underperformance was due to a 10% underweight to the materials sector, combined with a similar overweight to underperforming consumer discretionary stocks. These sector tilts dominated otherwise strong stock selection within sectors.

For example, consider two actual high conviction Australian equity managers. One follows a growth investing style, the other is a value manager. The value manager has a stock level *DI* value of 3.0%, while the growth manager has a stock level *DI* value of 2.8%. The sector level *DI* values are 7.6% and 3.3% respectively. Therefore, both managers have large sector bets in their portfolios. An equally-weighted portfolio of these two managers yields a sector level *DI* of 2.5%. This is a material reduction in sector bets, especially given the extreme sector positioning of the value manager. Importantly, this reduction in sector bias is possible without comprising each manager's stock picking skills in their respective portfolios. We have been able to reduce risk without lowering expected alpha.

Portfolio construction considerations

From a portfolio construction standpoint, the amount to allocate to high conviction Australian equity funds will depend on the individual investor's tolerance for increased tracking error. This allocation will generally

come at the expense of an existing allocation to Australian equities, as the decision to employ a high conviction approach is based on alpha and tracking error preferences, not underlying strategic asset allocation. Investors may allocate either part or all of their existing Australian equities exposure to high conviction managers, once again depending on risk tolerance. This paper shows that investors willing to take on this additional tracking error have, on average, been rewarded in the recent past.

Importantly, the multi-manager approach advocated here has all of the benefits of the increased alpha potential of high conviction approaches, without the burden of higher tracking error. A multi-manager approach provides a solid risk controlled alternative to what could be a very bumpy ride with individual high conviction managers.

Conclusion

High conviction equity funds offer investors the opportunity for higher returns than traditional, more diversified funds. This paper illustrates the relative outperformance of high conviction approaches in the Australian equity market over more traditional approaches, and provides evidence that the additional return exceeds the increased risk.

However, investing in a high conviction fund creates additional complications for investors. The wide dispersion of returns between high conviction managers means manager selection and monitoring is of critical importance. Sector and style biases also become important drivers of performance.

A solution is for investors to gain high conviction exposure through a fund-of-funds structure. This approach harnesses the manager selection skills of multi-managers and diversifies the risk that any individual style, sector or manager performance will dominate overall investment performance. In effect, a multi-manager approach moves the role of risk control from the individual manager to the multi-manager. This allows investment managers to focus on what they do best (picking stocks), while allowing the multi-manager portfolio manager to focus on what it does best (evaluating individual managers and bundling them to manage risks while retaining their return potential). ■

ENDNOTES

1. If a manager does have skill in timing sectors and/or factors, then the multi-manager structure can allow for this by deliberately not neutralising these risks for this manager. The key message is that a multi-manager can choose to exploit those risks it believes will be rewarded while neutralising those that it believes will not.

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Peter Gunning is Chief Investment Officer of Russell's investment management and research activities in the Asia Pacific region. His responsibilities include the oversight of investment research in the region as well as the management of Russell clients' Australian, New Zealand, Japanese and Australasian equity and fixed interest portfolios. Peter travels extensively to meet with investment managers who are evaluated and monitored as part of Russell's manager research process. He was a key participant in the launch of the ASX/Russell Style Indexes in April 1996 and he subsequently co-authored a number of seminal papers on the importance of style investing in the Australian equity market. Peter also lectures for the Securities Institute of Australia, teaching asset allocation, applied portfolio management, interest rate markets and risk management. Currently, Peter is a member of the Q-Group (Institute of Quantitative Research in Finance Inc), the Australian S&P/ASX Index Advisory Panel, and serves as a director to the North Shore Heart Research Foundation.

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