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Active Management: Revisiting the Publicized Merits of Concentrated Portfolio Construction

While conventional wisdom maintains that concentrated portfolios capture more idiosyncratic alpha, a deeper review reveals a far more nuanced conclusion.

For the past few years, the passive versus active debate has been characterized as a pitched battle between two sides. Upon closer inspection, however, some might recognize that this ongoing argument is far more nuanced than it appears at first blush and actually involves multiple sides with somewhat vague allegiances. Among actively managed funds, for instance, two distinct camps have emerged: those that favor a concentrated portfolio and those that espouse a highly diversified approach.

At one end of the spectrum are the actively managed funds that show a bias for concentration. These managers seek to build portfolios of approximately 25 to 40 stocks and aim to optimize returns by capturing idiosyncratic, stock-specific alpha through superior selection. On the other end are those that purport to minimize risk through constructing highly diversified portfolios comprised of as many as 180 positions that largely track the indexes and attempt to add alpha on the margins.

While many investment managers rely on absolutes to convey a clean and easy-to-understand narrative, the truth is that the diversification puzzle is far less black and white than many portray it to be. In fact, an efficient frontier exists in which a portfolio can hold a meaningfully higher number of stocks than most concentrated portfolios (between 80 and 100 generally), while also delivering idiosyncratic, stock-level alpha that comes from investments in high-quality assets with sound fundamentals, positive business momentum and attractive valuations. When diversification is a byproduct of rigorous analysis and bold, full-throated stock picking – and not merely an end in and of itself — it can yield similar returns as far more concentrated portfolios, albeit with materially lower risk and reduced volatility.

The Turning Tide Toward Concentration

To be sure, not all active funds are created equally, and if you exclude the benchmark-tracking performance of those considered to be closet indexers, the picture looks very different. Many investors and thought leaders within the allocation world have clearly recognized this issue and have sought out actively-managed concentrated funds as a result.

Central to this trend is the idea that even top fund managers are squandering their stock picking skills by over-diversifying. Many believe that a fund's analytical bandwidth, in which managers can gain conviction through an analytical or informational edge, has limits. They would suggest that to truly understand the business fundamentals and intrinsic value for as many as 100 different names – all while actively pursuing new ideas — is a fool's errand. There is also the contention that diversification automatically dilutes returns, whether a manager is trying to reach a notional optimized level of diversification or simply being driven by the fear of underperforming their benchmarks.

Helping to make the concentrated case appear more compelling are some of the more iconic investors who built their track record following this path. Warren Buffett, Bill Ackman and Seth Klarman, for instance, would likely argue that their more concentrated funds make it easier to marry security and balance-sheet analysis to understand the businesses in which they are investing. Academic literature even supports this theory. A 2012 paper that came out of *The Paul Woolley Centre* demonstrated the challenge of maintaining highly diversified portfolios. The research found that over a ten-year period ending in 2009, diversified U.S. equity mutual funds would have generated more attractive returns if they'd only stuck to their top weights.

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While there are certainly talented managers that can run concentrated portfolios successfully, there are very few in the league of Warren Buffett or Seth Klarman, and even fewer whose funds remain open to new investors. Conversely, there are many more managers who have tried this same strategy only to fail miserably and have had to subsequently shut down their funds. Without the benefit of capital that is either permanent or long-term in nature, the risk of concentration can be more pronounced for traditional fund managers as the threat of redemptions instills a short-term focus inconsistent with the investment theses supporting most concentrated strategies.

Diversification: Leveraging a Target-Rich Universe and Fundamental Analysis

The one constant in truly active funds is the work that goes into understanding the underlying economics of businesses and separating the relevant signals from the noise. Value-oriented, bottom-up investors benefit from analysis that is just as robust as that which goes into more concentrated portfolios. By winnowing down the investable universe using a quant-screening process, and sticking to a hard-wired philosophy and fundamental approach, managers can track business momentum and identify relative value in any economic environment and across markets. Having seasoned analysts with long tenures at the same firm is also a huge advantage.

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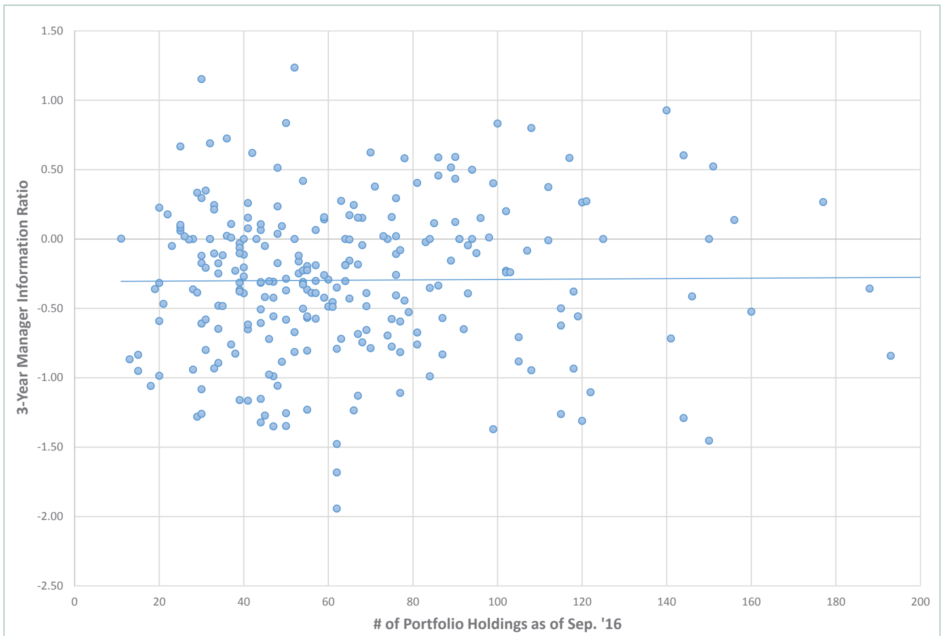
Ultimately the question of concentration versus diversification is far more complicated than saying if it works for Buffett then it is the right course. For instance, diversified portfolios with as many as 80 - 100 holdings can offer comparable returns to portfolios comprised of just 25 - 40 positions and at the same time have the distinct benefit of keeping risk and volatility at more moderate levels. By integrating quantitative capabilities with a traditional bottom-up focus on fundamentals, firms can expand both their investment universe and analytical bandwidth by zeroing in on the characteristics that drive valuations. This can ultimately allow fund managers to gain high conviction across an appropriately diversified fund that by definition will have less risk than a similar 25 - 40 stock portfolio.

Recent performance bears this out, as Leigh Walzer of Trapezoid, LLC, recently identified. Citing a sample of 70 fund managers that oversaw more concentrated versions of diversified, actively managed funds, Walzer found that in most cases the concentrated alternatives did worse. He highlighted that the impact was even more pronounced among the "Focused" or "Select Opportunities" funds with over $1 billion of assets under management. Walzer concluded that the higher concentration of these so-called focused funds "effectively magnified" the bad bets.

This example could bring to mind the recent travails of hedge fund manager Bill Ackman, whose massive bet on Valeant Pharmaceuticals in 2015 fell by over 75 percent. This example also demonstrates the vulnerability and cost of behavioral decision-making biases. For instance, "confirmation bias," in which a manager can fall in love with a stock, an investment thesis or a management team, can have a much bigger impact in a concentrated portfolio. For example, in a theoretical 40-stock portfolio, an overweight 600bp position that drops 20% will cost 120bp, three times as high as the same mistake in a 100-stock portfolio with a 200bp position.

But one well-publicized blow up and a small 70-sample example are not sufficient to necessarily make the case for a more nuanced and thorough examination of optimal concentration within portfolios. However, as shown in the exhibit below, a regression analysis demonstrates that concentrated portfolios, by themselves, fail to produce any measurable effect on a fund's ability to deliver alpha. The exhibit below uses eVestment's historical fund data across a universe of over 270 Large Cap Funds, tracking the number of holdings of each and the corresponding information ratio (which is the ratio of returns below the performance of the benchmark in relation to the volatility of those returns). As the graphic clearly shows, there is no connection between the level of concentration and the ability to capture alpha. Importantly, similar analysis across varying market caps, geographies and strategies yielded the same results.

Chart 1: eVestment Large Cap Manager Universe
Number of Holdings versus Risk-Adjusted Returns as of September 30, 2016



Source: eVestment, Boston Partners.

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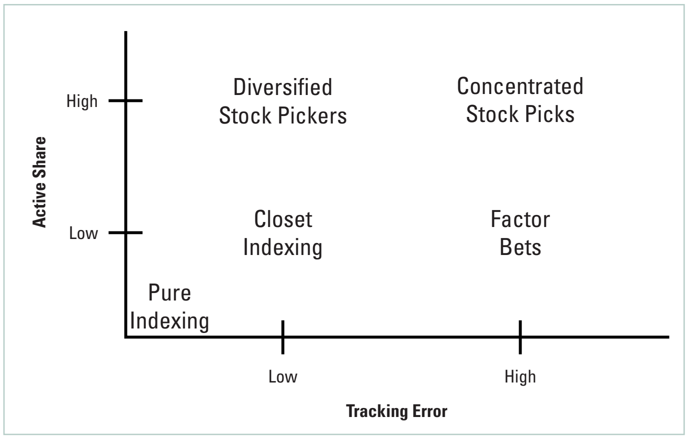
Clearly, high conviction often connotes binary outcomes and even the finest managers get a few of these outcomes wrong. In a 100-stock portfolio, where quantitative risk metrics can detect momentum reversals or failure rankings, both the likelihood and impact of falling in love with a stock and getting it wrong will be lower. This is even more important in a low-return regime, as the ability to avoid or minimize these blow ups can make a tremendous difference on returns over time.

Another unintended consequence is that many concentrated funds also assume unaccounted-for factor risks, which can offset the potential benefits of active stock picking. For example the "Taper Tantrum" of 2013 saw high yielding, safe stocks reverse by 900bp as the Fed tapered its Quantitative Easing program. In fact, Smart beta has become so inexpensive and so ubiquitous that there are more smart beta ETFs today than there are large cap funds. In other words, the tail is wagging the dog, with the performance of many stocks being driven by factor or characteristic drivers rather than fundamentals and intrinsic valuations. This is why idiosyncratic alpha, which captures the proportion of returns not related to common factor exposures, has become critical.

Active share, measuring how a portfolio differs from its index in terms of individual stock allocations, has become a proxy for portfolio “activeness” since it was introduced by former Yale professors Martijn Cremers and Antti Petajisto in 2009. It is also a good way to screen out closet indexers. The downside is that it doesn’t capture the variation in volatility across assets over time, nor does it reflect the level of diversification. Importantly, it does not clearly predict the ability to capture stock-level idiosyncratic alpha or fund outperformance. However, looking at the ratio of active share to tracking error — the difference between a portfolio’s returns and its respective benchmark — does more effectively take diversification and volatility considerations into account.

Chart 2: Fund Classification
Active Share versus Tracking Error



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The key to long-term outperformance, according to Petajisto, is maintaining a high active share relative to tracking error. Avoiding factor bets and excessive active share, which can lead to significant increases in tracking error beyond a certain point, is one way of doing that. It’s important to note that measures of risk such as active share or tracking error can create a false sense of security among investors, and even obscure corporate fundamentals like valuation risk, earnings risk and any loss of momentum.

So, while market “experts” may volley back and forth over the cost benefits of passive investing and the death of active management, the landscape for allocators will continue to focus on the pursuit of idiosyncratic alpha. This will clearly be of paramount importance, especially if we are indeed in a “lower-for-longer” regime or conversely if we are headed for a prolonged “risk on” period in which correlations across stocks drops meaningfully and it becomes a “stock pickers” market.

Within the larger active vs. passive debate perhaps the most important secondary question will be “Concentrated or Diversified?” While many contend that the industry has spoken loud and clear on this issue, we would respond that taking a deeper, more nuanced look can result in a surprisingly different answer. Very simply put, if a high active share portfolio of 80-100 stocks – selected as part of a disciplined, bottom-up research process — is enhanced by a set of robust quantitative capabilities, a byproduct will be a low tracking error portfolio with similar and perhaps better returns than funds comprised of 25-40 stocks. When you also consider the likelihood for added volatility, sparked by discrete events such as the June Brexit vote or the recent surprise election of Donald Trump, it would be imprudent not to think long and hard about the real merits of concentration.

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Mr. Farren is a senior portfolio analyst for Boston Partners. He joined the firm from Alliance Bernstein in New York where he spent over three years in a sales capacity covering Hedge Funds and concentrating on Event Driven Research. Prior to that he was a product engineer for SSGA's Fund of Funds product SSARIS, where he was responsible for client facing interactions with existing investors and potential allocators. Before that he spent four years at Tudor Investment Corporation working on the Raptor Fund as a fundamental analyst where he specialized in the restaurants, food and beverage companies, household products and miscellaneous consumer non-retail sectors of the equity market. He holds a B.A. in history and political science from Tufts University and an M.B.A. from the Kellogg School at Northwestern. He has twenty-two years of industry experience.

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