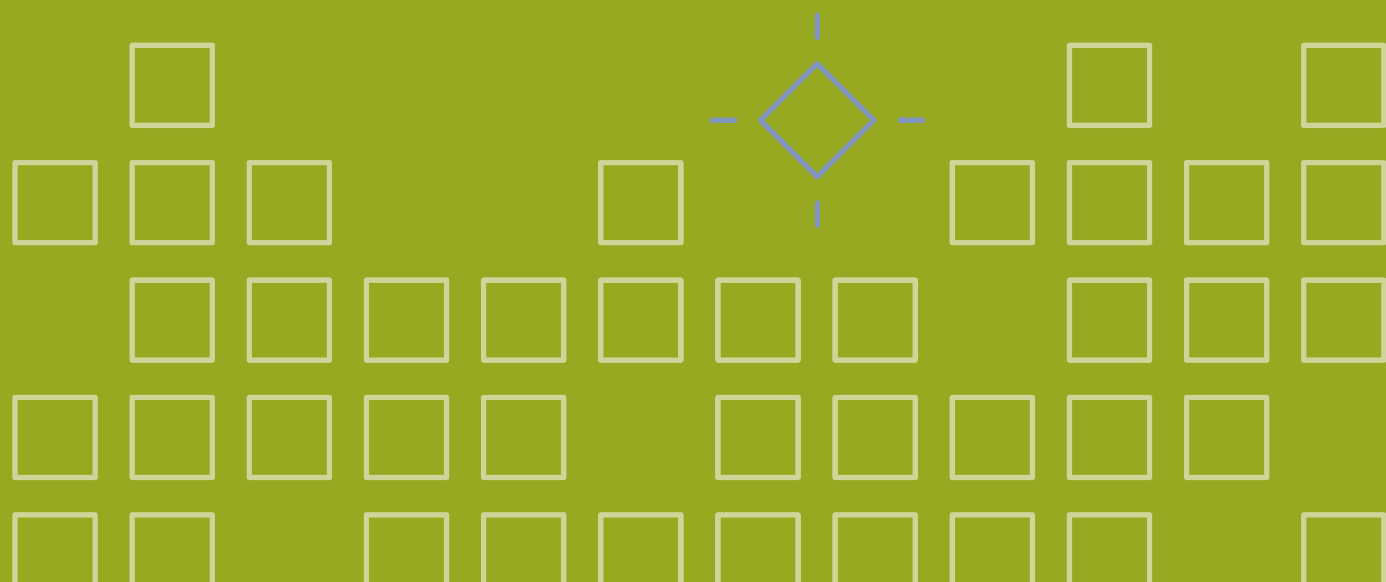
QUALITY OVER QUANTITY

CONCENTRATED EQUITIES



IN THIS PAPER: The last two decades have seen a dramatic migration toward passive equity approaches. Passive may be cheaper on the surface, but investors may be taking on more risk than they know. We think it makes sense to complement passive strategies with highly concentrated strategies—those that focus on quality over quantity with fewer, but higher-caliber, stocks. Our research shows that "concentrated" active managers have been very successful in terms of excess returns and risk-adjusted returns as well as downside risk reduction.

The last two decades have seen a dramatic migration of US and global equity investors toward passive approaches, especially in large-cap stocks. The common refrain: "Passive is cheaper and less risky." Many investors believe that it's better to spend their risk budget in places like international and small-cap, where they perceive better opportunities.

Sure, passive investing is cheaper on the surface, but we think investors are taking on more risk than they know. Higher volatility, especially at market peaks, makes the true cost and risk of passive investing higher than expected. As for international and small-cap stocks, it may not be better opportunities fueling alpha—but it could be their more diversified universe.

We think it makes sense to combine passive strategies with highly concentrated strategies that identify exceptional stocks. But it's fair for investors considering such an approach to ask pointed questions about its effectiveness:

+ Do concentrated portfolios outperform more diversified ones?
+ Do they produce higher levels of volatility?
+ Do they generate high tracking error?
+ How should an investor combine a low- and high-active share portfolio?

Let's tackle these questions head on.

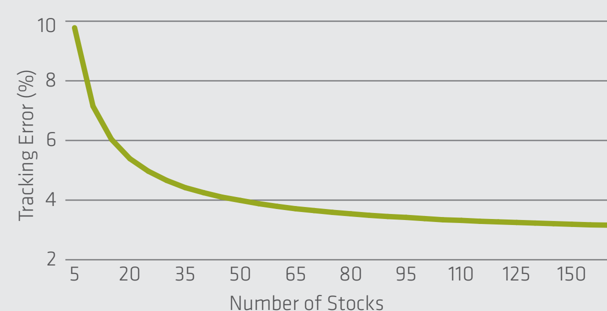
A CLOSER LOOK AT CONCENTRATED EQUITY INVESTING

It's a common assumption that the more stocks you add to an equity portfolio, the more it reduces volatility. That's true to a point. But beyond a threshold of 20 to 30 stocks, the marginal benefit of additional names is reduced (*Display 1*). This leaves a strong case to be made for quality of stocks, not quantity, in portfolio construction. By using research to focus on fewer but higher quality stocks, concentrated investing has the potential to produce substantial alpha through security selection, with adequate diversification across best ideas.

To put numbers to this concept, we categorized US equity managers based on the number of positions they hold.[1] We'll call managers with 35 or fewer stocks "concentrated" active managers. These managers tend to have very high "active share" (see *What Is Active Share?, next page*).

DISPLAY 1: HOW MUCH DIVERSIFICATION IS REALLY HELPFUL?

Incremental Diversification Benefits Decline Exponentially



As of December 31, 2015
Analysis based on 1,000 simulations of S&P 500 stocks randomly chosen and equally weighted in portfolios ranging from 5-150 holdings. Tracking error shown is the average for each portfolio.
Source: Standard & Poor's (S&P) and AB

Managers with 36 to 200 stocks can be referred to as "traditional" active managers. As a group, they have a fairly high active share, but it varies greatly within the category. Managers with more than 200 stocks are effectively "passive" investors with low active share.

Historically, concentrated managers have been very successful. The median concentrated manager has delivered 3.32% annualized rolling excess returns over the last five years and 3.76% over 10 years, gross of fees (*Display 2, next page*). Traditional managers have also produced excess returns, though lower than those of concentrated managers (1.80% over five years and 1.90% over 10 years). Passive managers have posted relatively flat excess returns over both time periods. Sometimes, there's power in fewer stock holdings.

1 Throughout this article **Concentrated Active Managers (35 or fewer holdings)** and **Traditional Active Managers (36 to 200 holdings)** are represented by 265 and 1,059 mid- and large-cap US equity strategies, respectively, and excludes sector-based strategies and those with no available holdings data for the last four quarters as of December 31, 2015. **Passive Managers** are represented by 52 passive strategies benchmarked to the S&P 500. Survivorship bias may skew the long-term results.
Source: eVestment, S&P and AB

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WHAT IS ACTIVE SHARE?

Active share gauges the level of active exposure for a specific manager. It measures the percentage of portfolio stock holdings that differ from those of the benchmark: the higher the active share, the more differentiated the manager relative to the benchmark. Active share helps identify "closet indexers": managers who claim to be active but really run benchmark-hugging portfolios.

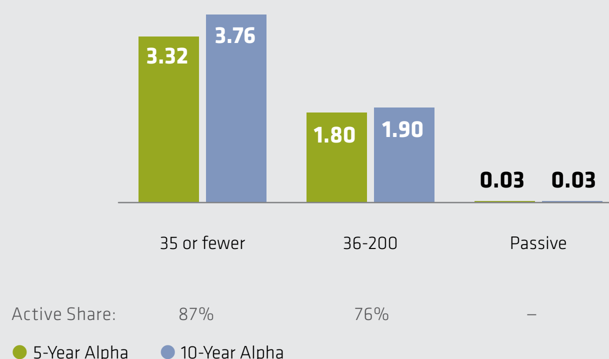
THE GROWING CHALLENGE OF FINDING ACTIVE MANAGERS

Ironically, even as concentrated investing has produced highly effective results, investors have allocated away from funds with high active share. Back in 1980, the market for high-active-share managers was broad—about 60% of US mutual fund assets. Over time, that share has dwindled as investors have migrated to cheaper sources of market exposure—managers with low active share such as ETFs and index funds. Today, high-active-share managers whose selectivity pinpoints the highest quality businesses make up less than 20% of the market.

Another challenge in finding concentrated managers is that active share isn't always a readily available characteristic, so investors need a proxy. One misstep is using tracking error—active risk relative to the benchmark—to gauge active share. Tracking error is actually much less effective as a stand-in for active share than concentration is. Over the five years ended June 30, 2013, the correlation between tracking error and active share was 0.50, substantially lower than the correlation between concentration and active share, which was 0.65.[2]

DISPLAY 2: CONCENTRATED APPROACHES THAT FOCUS ON STOCK QUALITY HAVE WORKED OVER TIME

Rolling Median Alpha (%)



Active Share: 87% 76% –

5-Year Alpha 10-Year Alpha

Past performance does not guarantee future results.
As of December 31, 2015
All data are shown gross of fees. Rolling periods are over a 15-year window.
Active share is a five-year average.
Source: eVestment, S&P and AB

HIDDEN RISKS OF PASSIVE: CHASING STRONG PERFORMERS

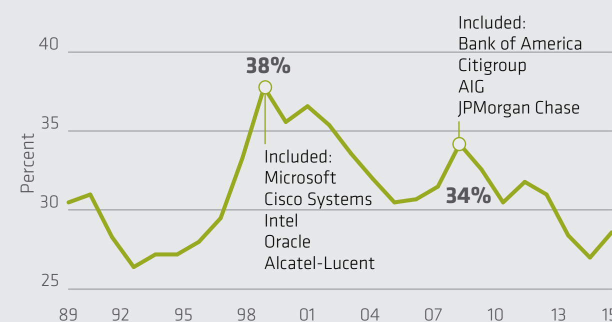
In our view, many investors are not only missing out on the benefits of concentrated investing, but they're overlooking very prominent risks that come with passive exposure. The problem boils down to chasing returns: by sector, market cap or region.

Sectors that have outperformed for an extended time see their market caps grow, so they command a bigger share of cap-based benchmarks. Take energy stocks in the 1970s: after a strong run, they grew to 27% of the S&P 500 Index by 1980. Passive portfolios would have followed along for the ride, with investors eventually allocating more than a quarter of their portfolios to energy stocks. Over the next two years, the energy sector lost about 51%.

A similar situation occurred as the tech bubble inflated. By 1999, tech stocks made up nearly 30% of the S&P 500. Also, the index's 20 biggest stocks by market cap accounted for about 38%, including companies like Microsoft, Cisco Systems, Intel, Oracle and Alcatel-Lucent (*Display 3*). These stocks tumbled badly after the bubble burst—declining more than 40% over the following year.

DISPLAY 3: THE PASSIVE PROBLEM: SECTOR CONCENTRATION

Weight of 20 Largest Stocks in S&P 500



Through December 31, 2015
Source: Barclays, Citigroup, FactSet, S&P and AB

2 Based on US large-cap universe.
Source: Cambridge Associates and eVestment

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Likewise, by 2008, a rally in financials boosted that sector to about 22% of the index. Market-cap concentration was pronounced, too: companies such as Bank of America, Citigroup, AIG and JPMorgan Chase were among the 20 largest stocks, accounting for a whopping 34% of the index combined. The following year, financials had declined by over 55%.

Focusing too much on past outperformers is a problem regionally, too. By the end of 1988, Japanese stocks had grown to an enormous 44% of the MSCI World Index. Following an indexed strategy would have led to almost half of an equity portfolio being invested in Japanese stocks. Over the nearly three ensuing decades, Japanese equities have remained well below that peak—and relative performance has been disappointing.

Indexed investing also forces investment decisions solely based on which stocks are included in or excluded from the index. When this happens, stocks that underperform shrink in size and are eventually taken out of the index, but index investors are compelled to follow them down until they're officially removed. On the flip side, stocks that outperform early in their earnings cycle won't be added to an index until their market capitalization passes the threshold defined by the guidelines of the index sponsor.

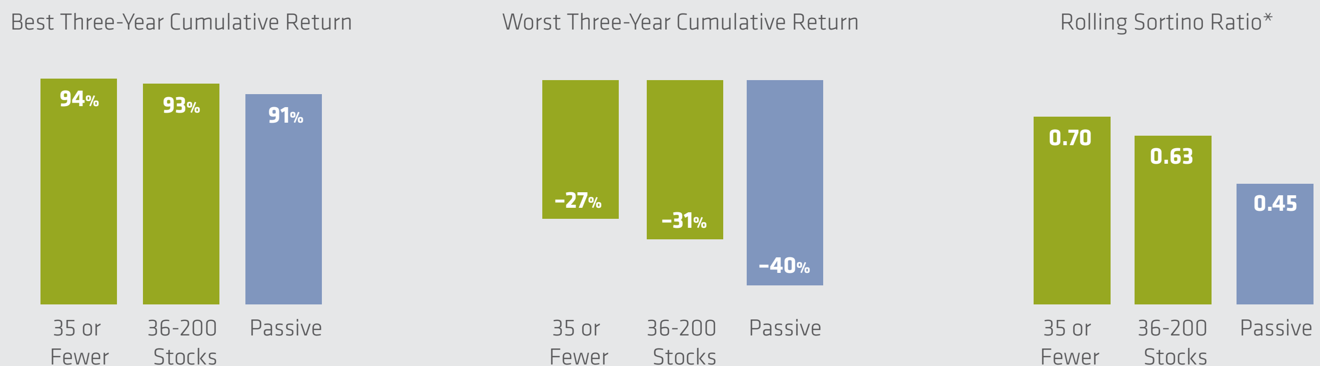
CONCENTRATED INVESTING MAY REDUCE DOWNSIDE RISK

Concentrated investing may seem to have its own risks, given its sizable weightings in fewer names, but it has actually provided a better risk/return profile than traditional or passive strategies.

One aspect is the upside/downside capture, which shows the percentage of up and down markets "captured" by an investment. Concentrated managers have delivered solid upside capture over the past 15 years, although less than that of traditional strategies. But their downside capture of 89% is lower than that of traditional managers (96%) and passive managers (100%).

During the 15-year period ending December 31, 2015, the worst three-year cumulative loss for concentrated managers was 27%,

DISPLAY 4: CAN A CONCENTRATED APPROACH REDUCE DOWNSIDE RISK WHILE PARTICIPATING IN UP MARKETS?



Past performance does not guarantee future results.
As of December 31, 2015
All data are shown gross of fees. Rolling periods are over a 15-year window.
* Sortino ratio is similar to Sharpe ratio except that it seeks to differentiate negative volatility from general volatility by incorporating the standard deviation of negative asset returns, or downside deviation, into the calculation. It is calculated by taking the manager's excess return and dividing it by the downside deviation.
Source: eVestment, S&P and AB

lower than both traditional (31%) and passive (40%). Concentrated delivered better upside, too—its top three-year return of 94% beat both traditional (93%) and passive (91%) (*Display 4, previous page*).

By evaluating the potential size of losses, the Sortino ratio offers another way to understand risk-adjusted returns. It's similar to the Sharpe ratio, which divides the return in excess of a risk-free rate by the total portfolio volatility. With Sortino, only the downside volatility is considered; the higher the ratio, the better investors are being compensated for potential downside risk. For concentrated strategies, the Sortino ratio has been 0.70 versus 0.63 for traditional managers and 0.45 for passive managers (*Display 4, previous page*).

Taken together, these data suggest that investors who stick with a concentrated approach over the long run have been rewarded with better returns with less downside volatility.

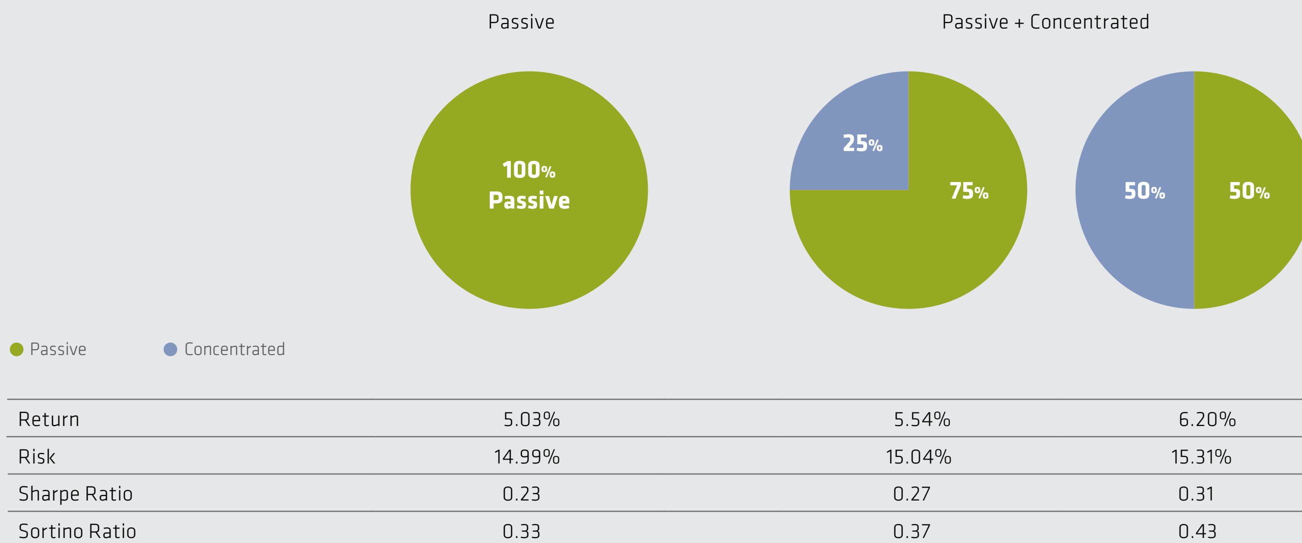
THE BENEFIT OF BLENDING CONCENTRATED AND PASSIVE

While concentrated investing is attractive in its own right, it can also be effective as a complement to passive investing. Over the 15 years ending December 31, 2015, a blend of 50% concentrated equities and 50% passive equities produced a higher annualized gross-of-fee return than a passive-only strategy (*Display 5*) with similar risk, resulting in a better Sharpe ratio. The blended strategy was also better in terms of downside protection, with a higher Sortino ratio.

CONCENTRATED ON QUALITY

Investors who limit themselves to passive investment strategies because of lower costs are missing the big picture—and likely taking on unintended risk. Instead of bulking up on stocks, concentrated portfolios emphasize quality over quantity by focusing on a smaller number of high-caliber companies. As history has shown, this strategy has led to a portfolio with attractive excess and risk-adjusted returns with reduced downside risk, proving that sometimes, less really is more.

DISPLAY 5: A COMBINED APPROACH IMPROVES RISK-ADJUSTED RETURN POTENTIAL



	Passive	Passive + Concentrated (75/25)	Passive + Concentrated (50/50)
Return	5.03%	5.54%	6.20%
Risk	14.99%	15.04%	15.31%
Sharpe Ratio	0.23	0.27	0.31
Sortino Ratio	0.33	0.37	0.43

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As of December 31, 2015
All data are shown gross of fees. Analysis is over a 15-year window.
Source: eVestment and AB

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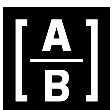

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