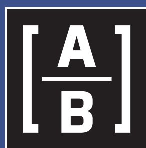

SHARPENING CONVICTION

NEW IDEAS TO ACTIVATE YOUR EQUITIES

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IN THIS PAPER: Investing with conviction is about applying knowledge, judgment and experience in an active stock-picking approach with a clearly defined angle on the market. By rethinking how different types of high-conviction strategies are chosen and combined, we believe that investors can discover better ways to make their equity portfolios work harder in a world of lower expected returns. Identifying strategies that demonstrate persistent conviction can provide investors with new ideas to help achieve their goals.

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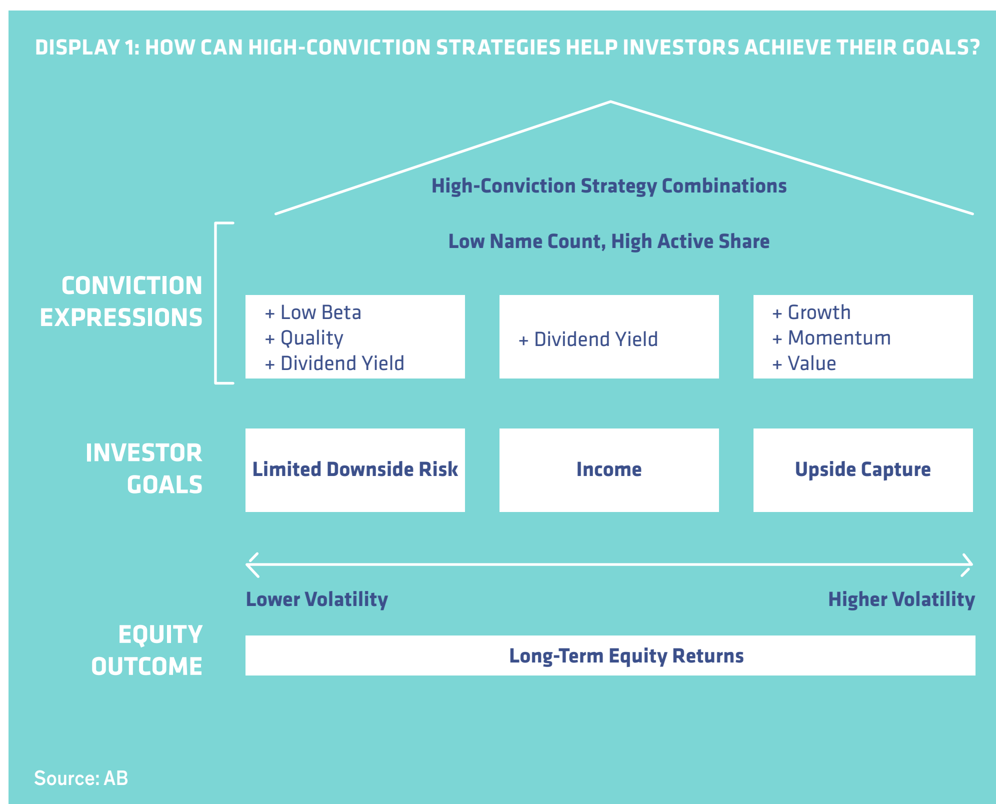
IDENTIFYING SKILL AND HIGH CONVICTION

Investing in equity markets requires confidence. It takes guts to invest in a Chinese Internet company when the world's biggest economy is slowing down. You need to be self-assured to buy into a drugmaker whose growth prospects depend on an unproven treatment. And when oil prices are tumbling, taking a position in a US energy group warrants more than a measure of bravado.

But without skill, confidence isn't worth much. In the examples above, and countless more, it takes skill based on years of experience to develop a differentiated view to underpin high conviction. Today, many investors have moved their equity allocations away from active approaches to index strategies because they're skeptical about stockpicking. In this paper, we show how investors can identify skilled high-conviction managers and create effective combinations to source consistent, long-term equity returns (*Display 1*).

DISPLAY 1: HOW CAN HIGH-CONVICTION STRATEGIES HELP INVESTORS ACHIEVE THEIR GOALS?



Source: AB

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Today, passive approaches are very popular. Many investors have lost faith in diversified active portfolios because of their disappointing and inconsistent performance, as well as their high fees relative to passive peers. But investing in an index alone could leave investors short of their goals. With market returns likely to be much lower in the coming decade, we believe that beating the market matters more today.

There's another way to seek alpha in equity portfolios. It starts by rethinking how different types of active strategies are chosen and deployed—and by focusing on true conviction. In our view, skilled high-conviction stock pickers have a clearly defined angle on the market, built on knowledge, judgment and experience. When these attributes are rigorously applied to an equity portfolio, all of the components of equity market returns can be captured to deliver powerful results.

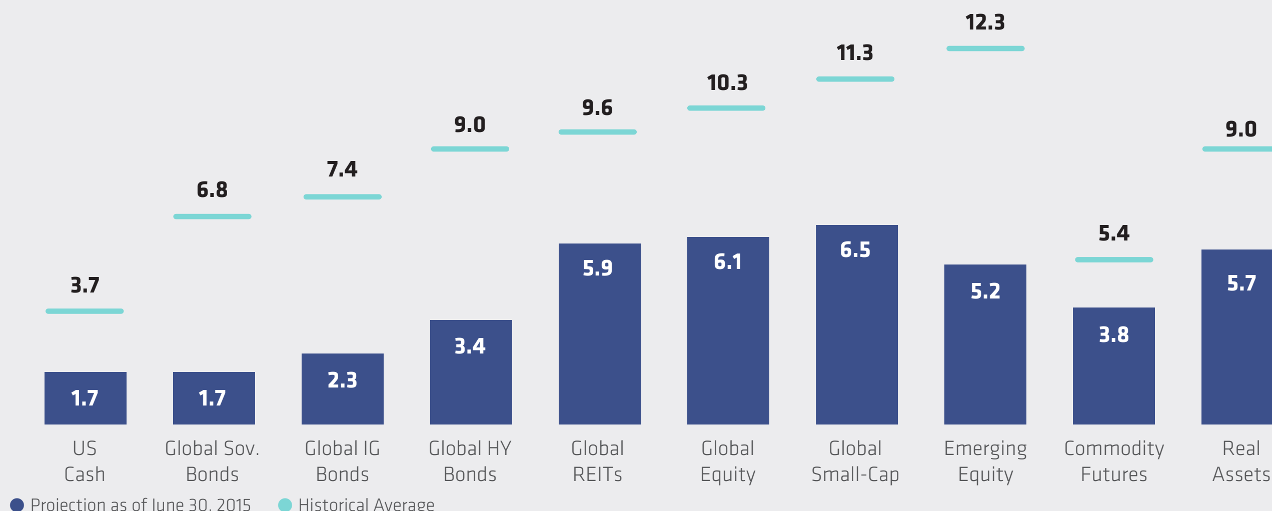
RETURNS ARE HARDER TO FIND

No matter where you look in the capital markets, it's getting harder to find returns. The outlook is sobering. From stocks to bonds to real assets, our forecasts indicate that all major asset classes are likely to deliver lower results going forward than they have over the past 30 years (*Display 2*).

Stock returns are likely to be subdued. Our Capital Markets Engine, which projects 10,000 plausible paths for major asset classes based on existing market conditions, estimates that the median return for global equities will be 6.1% a year over the next decade. This is well below the 10.3% average return over the past three decades.

DISPLAY 2: RETURN OUTLOOK IS BELOW AVERAGE FOR ALL MAJOR ASSET CLASSES

Forecast 10-Year Annualized Growth Rates (Percent)



Data do not represent past performance and are not a promise of actual results or a range of future results.

As of June 30, 2015

Emerging equity is unhedged in US dollars. All other asset classes are hedged in US dollars.

Returns above the line represent long-term historical averages over 30 years through December 31, 2014.

We project 10,000 plausible paths for major asset classes, and use them to quantify the median of returns.

Equity markets referenced represent broad universes similar to the corresponding MSCI indices: for example, global equity represents a universe similar to the MSCI World. The bond markets referenced are for seven-year constant-maturity bonds of the type named: nominal sovereign (Sov.), high-yield (HY) and investment-grade (IG) corporate. Commodity futures represent the Dow Jones Commodity Index. Real assets are modeled as one-third REITs, one-third commodity futures and one-third commodity stocks.

Source: AB

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Beating the market by a small margin can make a big difference.

After equity markets posted strong returns over the past few years, valuations have increased, while interest rates remain at record lows and the economic recovery has matured. As a result, in the coming years, we expect equity returns to be driven mainly by earnings and dividend growth, and not by an expansion of multiples. And yet, despite these changing dynamics, our projected equity returns still look much more attractive than forecast returns from fixed income.

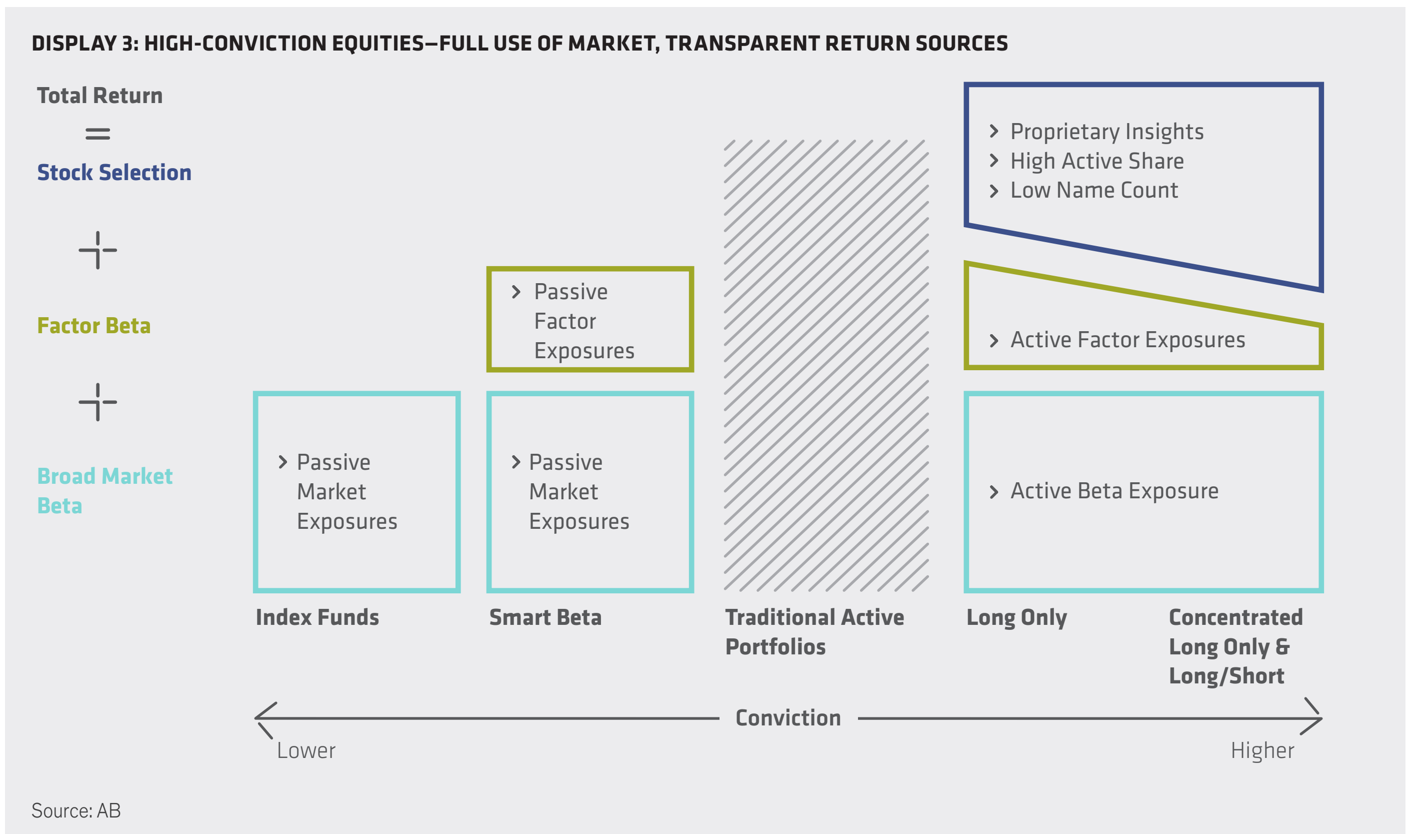
In this environment, beating the market by even a small margin of 1% a year can make a big difference. Yet many investors aren't even trying to do that. Even in a world of diminishing returns, passive investing is playing a bigger role in equity allocations.

Part of the appeal of passive investing is driven by market innovations. In traditional active portfolios, investors didn't really know how much of their returns were coming from the market, from factor exposures, or from manager skill (*Display 3*). Today, investors can buy two components of equity returns—broad market exposure and factor exposure—fairly cheaply. However, there could be an opportunity cost to pay by forgoing returns from stock selection. The question is, can investors find a better way to capture the potential of stock selection skill?

WHAT DOES CONVICTION REALLY MEAN?

Conviction and skill are complementary ingredients for long-term investment success, but the former isn't proof of the latter. Since 2009, active share has dominated the conviction debate. It started with a seminal academic study by Martijn Cremers and Antti Petajisto, which showed that investment managers with high active share had significant outperformance relative to their benchmarks.[1] This led to a very appealing proposition. Since active share is a simple, straightforward calculation, many investors put high active share at the center of their selection processes. Active share was widely seen as a measure of manager skill.

DISPLAY 3: HIGH-CONVICTION EQUITIES—FULL USE OF MARKET, TRANSPARENT RETURN SOURCES



Source: AB

1 K.J. Martijn Cremers and Antti Petajisto, "How Active Is Your Fund Manager? A New Measure That Predicts Performance," *The Review of Financial Studies* 22, no. 9 (2009): 3329–3365.

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High active share is important. But it isn't everything. Portfolio managers with high active share clearly have confidence, as they construct portfolios that are very different from the benchmark. Yet high active share doesn't tell you whether a manager has any skill at all; a portfolio manager may differ from the benchmark dramatically by holding large positions that don't do well and that drag down absolute and relative returns.

Our definition of skilled high conviction has several layers, and is broader than just high active share. First, a portfolio built with conviction must have a clear investing philosophy backed by strong research capabilities in order to capture the manager's proprietary insights. That's because having an underlying rationale to guide stockpicking helps ensure that a portfolio manager isn't just taking outsized positions arbitrarily. Second, a disciplined process is crucial. Third, a high-conviction portfolio must differ meaningfully from the benchmark based on a coherent investing philosophy. High-conviction managers must also be capable of standing by their research findings, even when faced with big challenges. And yet they must also have the humility to know when to step back and revisit an investing thesis if circumstances change.

When viewed through this lens, conviction can take many forms. It might be an emerging-market equities manager with a clear growth philosophy that drives a portfolio made up of holdings with strong multiyear growth prospects and high return on equity. Or a manager who invests in deep-value stocks against the tide. Even portfolios focused on dividend-yield stocks or stocks with lower volatility characteristics—usually considered more defensive—can be considered high-conviction strategies if they execute a clear, consistent philosophy. These are all approaches that can reflect conviction. They can be implemented in diversified portfolios with high active share or concentrated portfolios with a small number of stocks.

For this study, we focused on eight expressions of high-conviction equity investing, including, among others, dividend-yield, value, quality, growth and concentrated approaches. We chose these groups for two reasons. First, they collectively represent a large portion of equity strategies that can be considered high conviction. Second, these categories represent different and complementary types of strategies that can be effectively combined in an overall portfolio allocation. Our research focused on portfolio managers that consistently demonstrated commitment and skill at a specific type of

IDENTIFYING CONVICTION: METHODOLOGY*

Many manifestations of conviction are intangibles. So identifying high conviction requires a methodology that can isolate portfolio managers who fit the mold.

For each category, we started by choosing a defining characteristic. For example, in value, it's low price/book value; quality is high return on equity; momentum is high rolling six-month returns; and growth is high year-over-year earnings growth.

Our research aimed to identify portfolio managers who consistently demonstrated conviction and skill at a specific type of investing discipline. To identify conviction, we focused on US Large Cap Equity portfolios in the eVestment universe from 2004 to 2014, using holdings data from Style Research. From this group, we singled out managers who reported holdings for at least three years and were in the top 20% of our high-conviction metric in each of these categories at least 60% of the time. Then, we identified skill by extracting those managers who delivered above-median returns for the period in which they reported. In some years, that top-half manager did not beat the benchmark, but was included in our universe nonetheless.

We're conducting additional research to support methodologies that will help investors select a skilled, high-conviction manager. The early evidence indicates that managers who stay in their high-conviction universe longer tend to post better performance. For example, managers who are in a high-conviction universe for more than five years outperform managers who are in that universe for less than five years by 52 basis points. We're also pursuing additional research on the persistence of alpha and how to determine whether a manager possesses skill. While we believe our analysis can help investors focus on the most promising portfolio managers, there is no substitute for a deep analysis and understanding of each manager's process and philosophy.

In this paper, we focused on a US universe because the size of the global universe is much smaller. We began our work from the beginning of the Style Research data series in eVestment for portfolio characteristics from 2004 through June 2014, the last available date at the time of our study.

*For more details, see Appendix, page 12.

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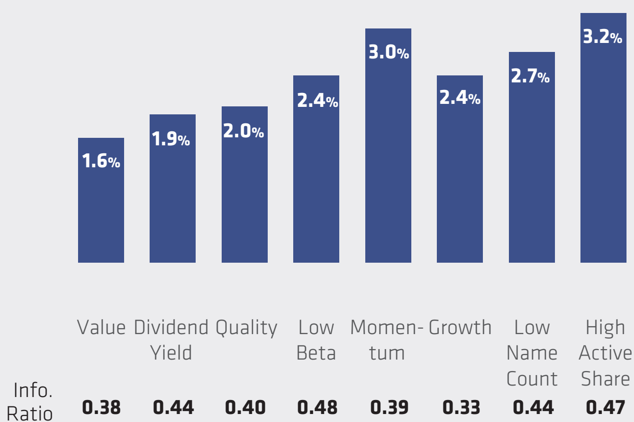
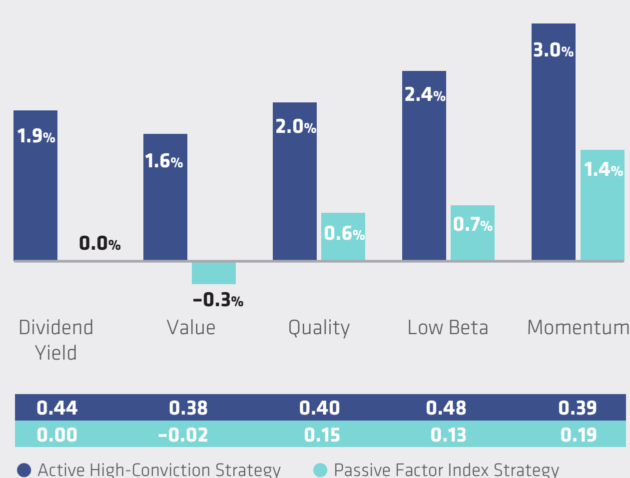
DISPLAY 4: SKILLED HIGH-CONVICTION STRATEGIES HAVE A SOLID TRACK RECORD

Annualized Relative Performance of Skilled High-Conviction Strategies (Jan 2004–Dec 2014)





Past performance does not guarantee future results.

Through December 31, 2014

Using data from Style Research, high-conviction strategies are defined as the top 20% of managers who consistently display a high-conviction characteristic in the eVestment US Large Cap Equity universe. Within each high-conviction category universe, the representative performance of skilled high-conviction strategies is the average of all managers whose performance is greater than that of the median manager over the period in which they reported. Monthly outlier returns are capped at the fifth percentile. A manager may be classified in more than one category. These numbers do not represent the performance history of any AB-managed product, but do include AB services if they meet the criteria of one of the universes. For further details, please see methodology notes in the Appendix.

*Factor index performance represents the returns of the MSCI indices—dividend yield: MSCI USA High Dividend Yield; value: MSCI USA Value; quality: MSCI USA Quality; low beta: MSCI USA Minimum Volatility; momentum: MSCI USA Momentum. These indices may not be investable and do not take into account transaction costs.

Source: eVestment, MSCI, S&P, Style Research and AB

investing discipline (for details on our methodology, *see* “Identifying Conviction: Methodology,” *previous page*). In the next section, we will show how different types of high-conviction equity strategies performed versus the broader market, against passive factor indices, and in different market environments. Then, we will demonstrate how investors can combine high-conviction strategies in different ways to achieve more consistent alpha in their equity allocations.

HIGH-CONVICTION EQUITY PERFORMANCE PATTERNS

High-conviction equities packed a big punch. From 2004 to 2014, skilled high-conviction equity managers outperformed the S&P 500 Index by a significant margin (*Display 4, left*), gross of fees. And strong information ratios indicate attractive risk-adjusted returns.

The outperformance ranged from 1.6% and 1.9% in the value and dividend-yield categories, respectively, through 3.0% and 3.2% in the momentum and high active share categories, respectively. These are meaningful premiums to the benchmark, even after fees, which are, of course, the critical issue for investors.

Skeptics may argue that passive approaches would do just as well. Perhaps a smart-beta approach focused on dividend yield or value stocks could get the job done at a much lower cost. We put this critique to the test by comparing five of the high-conviction groups that had representative passive MSCI indices as their factor benchmark. Here, too, the active skilled high-conviction strategies easily beat the passive factor indices (*Display 4, right*).

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FIND THE SWEET SPOTS

THINK DIFFERENTLY ABOUT CONVICTION

Lower name count and higher active share are often seen as the hallmarks of conviction in equity investing. We think differently. While both of these characteristics are important, not every portfolio will benefit from more concentration or a higher active share. In fact, the "sweet spots" differ from group to group.

For example, skilled high-conviction dividend-yield strategies held, on average, 75 stocks and had a 75% active share from 2004 to 2014. This is a higher number of holdings and a lower active share than often referenced in traditional definitions of conviction. Here, conviction is expressed by risk-taking through yield exposure—and rewarded with a premium of 1.9% to the benchmark.

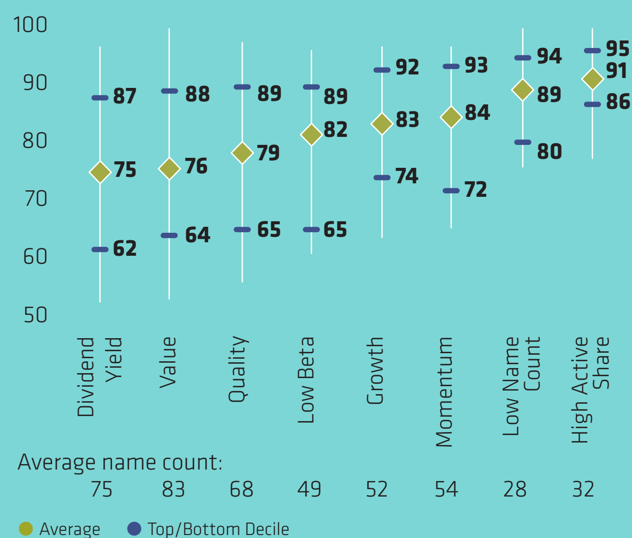
It's also clear that the sweet spot for high active share is less important for some strategies than for others. For example, in value portfolios, the best results were in portfolios with an average of 83 stocks and an active share of 76%. This observation is important. In value, individual value stocks have more single-stock volatility because they face uncertainty in a future earnings outcome. In this case, building a portfolio with low name count or higher active share may result in taking on risk that isn't necessary in order to be rewarded.

It is also interesting to look at the range of active share across high-conviction managers in each category. In the value category, for example, the range was also quite wide, with the lowest decile averaging just 64% active share, while the highest decile came in at 88%. This is an indication that active share may be an outcome for some, but not all, skilled high-conviction managers in this category (*Display*). Over the period we studied, the ranges for skilled high-conviction managers in dividend yield, value, quality and low beta were widest.

With this intelligence, investors can make more informed decisions when screening or selecting managers to ensure that they don't take more risk than necessary.

IS ACTIVE SHARE THE KEY TO CONVICTION?

Skilled High-Conviction Managers, Active Share (Percent)



Using data from Style Research, high-conviction strategies are defined as the top 20% of managers who consistently display a high-conviction characteristic in the eVestment US Large Cap Equity universe. Characteristics shown are for the high-conviction managers whose performance is above median within their high-conviction strategy universe, based on characteristics through June 30, 2014, owing to data availability. For further details on how we sampled managers, please see methodology notes in the Appendix.
Values shown are the average of yearly top-decile, bottom-decile and average active share and name count among those managers each year between 2004 and 2014.
Source: eVestment, S&P, Style Research and AB

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> No single strategy is consistently at the top or bottom.

DISPLAY 5: EQUITY RETURN PATTERNS VARY FROM YEAR TO YEAR

Factor Index Performance (Percent)

Rank	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
1	16.4	18.8	22.0	17.4	-26.2	31.1	17.8	13.1	16.0	34.0	15.8
2	14.6	6.0	19.9	10.1	-28.5	26.5	15.1	11.9	15.0	32.8	14.2
3	13.8	5.9	15.8	5.5	-30.6	18.1	14.6	7.7	14.3	32.4	13.8
4	10.9	4.9	14.2	3.6	-35.4	17.5	14.4	5.5	11.0	32.3	13.7
5	10.8	2.7	11.4	0.5	-37.0	17.1	13.8	2.1	10.2	27.6	12.3
6	9.6	2.0	10.4	-1.0	-41.1	16.9	11.9	1.5	9.5	24.4	11.2

● MSCI USA Momentum ● MSCI USA High Dividend Yield ● MSCI USA Value ○ S&P 500 ● MSCI USA Minimum Volatility ● MSCI USA Quality

Past performance is not a guarantee of future results.
Through December 31, 2014
Source: MSCI, S&P and AB

ASSESSING PERFORMANCE IN CHANGING MARKETS

As market conditions change, a thoughtful approach to portfolio-allocation decisions is critical to successful investing. Imagine it was 2009, and you had a big allocation to quality strategies, which delivered a return of 31.1% that year, ranking highest among rival equity categories. Just one year later, quality was at the bottom of the pack, returning a healthy 11.9%, but well below other types of equities.

Seasoned investors are familiar with the problem. One year's winner is the next year's loser. Just as the performance of different asset classes can vary from year to year, return patterns for different equity strategies vary from year to year, as the quilt chart shows (*Display 5*). No single strategy is consistently at the top or the bottom.

RISING AND FALLING MARKETS MATTER

So to gain comfort in deploying high-conviction equity allocations, it's important to understand how market conditions can affect their behavior. Rising and falling markets matter. To find out how much they matter, we looked at the annualized relative return of skilled high-conviction managers in the best third of market returns and worst third of market returns over the past decade.

When markets were falling, managers who featured low beta, dividend yield and quality provided the best downside protection (*Display 6, next page*). This makes sense given the more defensive characteristics of these factors.

When markets were rising, managers with a clear focus on value, growth and momentum provided the best upside capture. This, too, makes sense because these factors are driven by longer-term earnings growth and recovery.

What about strategies with low name count or high active share? On average, these types of portfolios were less sensitive to the surrounding environment and delivered positive alpha in both the best and worst thirds of the market. But there's a catch. In these portfolios, there was a much wider dispersion of returns when compared with other high-conviction strategies (*Display 7, next page*; *see Appendix, page 13*, for detailed dispersion data). In other words, by relying only on low name count or high active share as expressions of high conviction, investors may sacrifice consistency.

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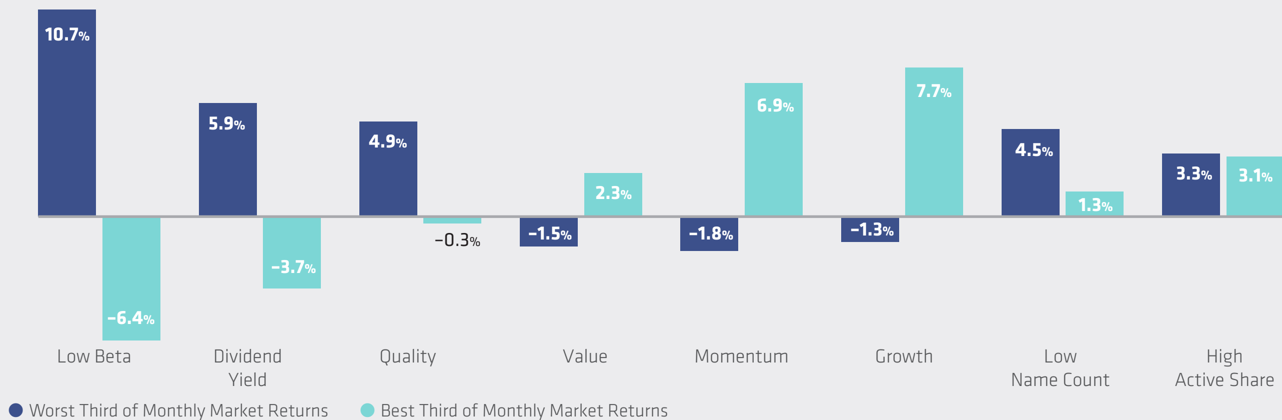
DISPLAY 6: MARKET DIRECTION MATTERS FOR DIFFERENT CONVICTION STRATEGIES

Downside Protection and Upside Capture of Skilled High-Conviction Strategies, Annualized Relative Returns (vs. S&P 500, Jan 2004–Dec 2014)



Past performance is not a guarantee of future results.

Through December 31, 2014

Characteristics shown are for managers that we identified as skilled high-conviction managers, as described in our methodology notes in the Appendix. Monthly outlier returns are capped at the fifth percentile.

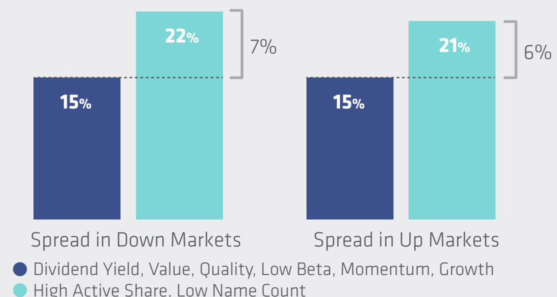
Source: eVestment, S&P, Style Research and AB

While the average dispersions of returns in Display 7 are about six and seven percentage points, the underlying numbers provide deeper insight into the benefits of focusing on more than just high active share when choosing high-conviction strategies. The range of relative returns for the bottom 20 percent and top 20 percent of managers in the high active share category in down markets was –12% to +12%. In down markets, returns for low-beta conviction strategies ranged from +4% for the bottom managers to +15% for the best-performing group. So in this example, not only is the range narrower, but the direction is as we would expect, since low-beta stocks should outperform in down markets. As a result, investors have more clarity because all managers in this category can be expected to outperform to varying degrees. Similarly, the range of relative returns for high active share in up markets was –8% to +14%, while high earnings growth—a strategy that is expected to do well in up markets—ranged from +1% to +15%.

The wider range of returns among high active share and concentrated portfolios may be a result of the limitations of these groupings as conviction metrics. Both of these measures don't provide any information about a portfolio's underlying philosophy. As a result, in

DISPLAY 7: WIDER RETURN DISPERSION IN HIGH ACTIVE SHARE AND CONCENTRATED STRATEGIES

Return Spread Between Best and Worst High-Conviction Managers



Past performance is not a guarantee of future results.

As of December 31, 2014

Return dispersion calculated as the difference between the average return of the top 20% of managers and the average return of the bottom 20% of managers in up months and then in down months, by high-conviction category. Monthly outlier returns are capped at the fifth percentile.

Source: eVestment, S&P, Style Research and AB

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different market conditions, their performance can be expected to vary. In high-conviction strategies with a clear approach, the narrower dispersion reflects the fact that there's much more visibility about how these portfolios invest and how they are likely to perform in changing market conditions.

Even with a clear philosophy as a compass, maintaining conviction isn't always easy. When markets are falling, conviction managers of all stripes may face pressure to stray from their areas of focus in order to add protection to a portfolio. So in order to invest effectively in changing markets, it's important to have some exposure to different types of strategies and the ability to stick with those exposures over a full market cycle. This helps ensure that the strongest years of performance offset the weaker periods.

FINDING CONSISTENT ALPHA

Every investor approaches the equity market with a different goal. For some, the memory of the 2008 financial crisis evokes a sense of insecurity, so limiting downside risk is their highest priority. Others may have a higher risk tolerance and will focus on beating the benchmark by a wide margin—despite the risks. And today, many investors want to find better ways to source consistent alpha from erratic markets.

Different types of high-conviction strategies are typically associated with each type of outcome. In fact, all of these approaches can work well for diverse investor goals. But our research suggests that by creating combinations of different types of high-conviction strategies, more consistent outcomes with better risk-adjusted returns can be achieved.

THE CONCENTRATED CONUNDRUM

Using just a single type of high-conviction approach isn't always effective. Take concentrated equities as an example. Concentrated equities are an integral part of a high-conviction tool kit. Yet they tend to have higher levels of tracking error, so the magnitude by which they can outperform or underperform a passive index is larger. It's also harder to predict their correlations to their peers. So how can you reduce risk in a package of concentrated equities?

In our example, we started by looking at a single concentrated portfolio, ranking at the 30th percentile, with a very high tracking error of more than 6% (*Display 8*). Putting together three concentrated portfolios reduced the tracking error to just above 4%. And it took five concentrated equity portfolios to reduce the tracking error by half, to about 3%.

DISPLAY 8: CONCENTRATED MANAGERS

More Needed to Lower Risk

Past performance is not a guarantee of future results.

As of December 31, 2014

Using data from Style Research, high-conviction strategies are defined as the top 20% of managers who consistently display a high-conviction characteristic in the eVestment US Large Cap Equity universe. Performance shown is for the 30th-percentile manager in each high-conviction strategy universe from 2004 to 2014. In this analysis, one manager is the 30th percentile manager; three managers are the 25th-, 30th- and 35th-percentile managers, equally weighted; and five managers are the 20th-, 25th-, 30th-, 35th- and 40th-percentile managers, equally weighted. For further details, please see methodology notes in the Appendix. Allocations are rebalanced monthly without consideration for transaction costs.

Source: eVestment, S&P, Style Research and AB

Concentrated equities play an important role in a high-conviction equity allocation, in our view. They are often less benchmark sensitive, can cushion declines in down markets, and manifest the best of stock-selection alpha, with low correlation to many other high-conviction strategies. We believe that concentrated approaches are especially effective when they're based on a differentiated investment philosophy with a clear approach, so an investor knows what's likely to drive returns.

More broadly, understanding how conviction is expressed in any equity portfolio is the key to getting better results. One advantage of expressing conviction through factors is that investors can get a similar tracking error reduction from fewer managers. To test this, it's important to understand how different strategies perform together.

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Conviction combinations help smooth the ride.

The first step is to identify strategies with low correlations to each other. In the following examples, we've created hypothetical portfolios by combining 30th-percentile performers within high-conviction categories. Each combination provided exposure to strategies that aimed to provide both downside protection and upside capture.

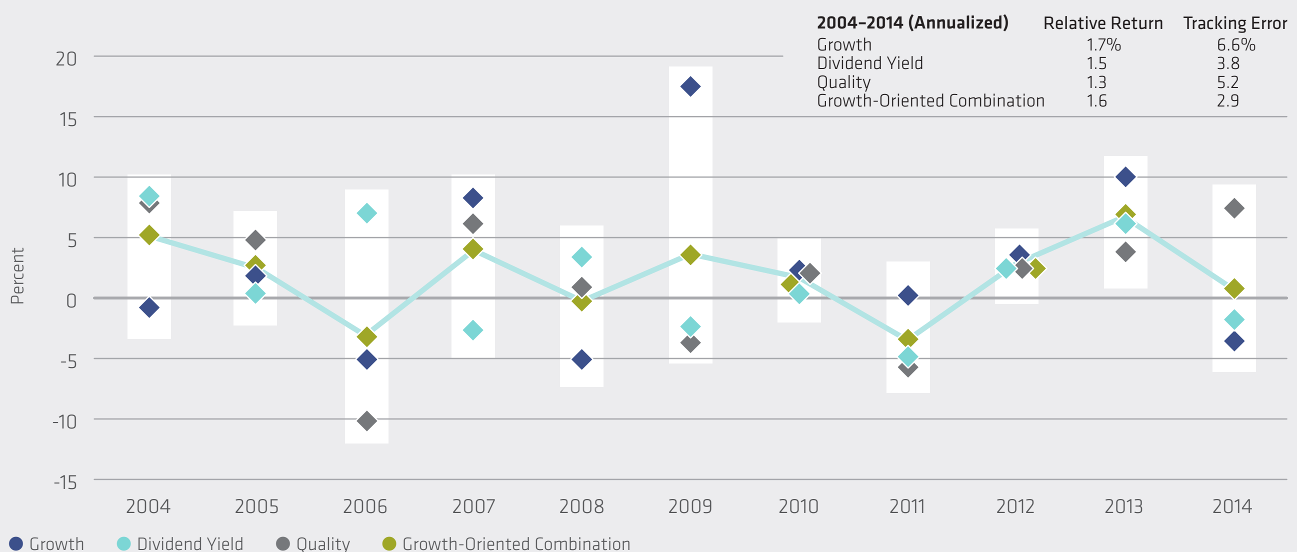
CONVICTION COMBINATIONS: GROWTH AND DIVIDEND YIELD

Investing in companies that are likely to deliver surprising long-term growth is especially exciting in an era of technological transformation. But growth investors know that volatility can deal a painful blow to short-term performance. In this example, we combined a high-conviction growth portfolio with a high-conviction dividend yield portfolio and a high-conviction quality portfolio, with each component allocated a third of the total.

As *Display 9* shows, there was a wide spread of returns for each individual portfolio from year to year. By creating a growth-oriented combination, however, the dispersion of returns from year to year narrowed significantly. In other words, the offsetting characteristics of each type of high-conviction strategy delivered an explicit diversification benefit; even though the end result for the entire 11-year period was similar, as the box shows, investors' experience in the growth-oriented combination was much smoother than it would have been with any individual manager. And it only took three managers to achieve a result that required five individual concentrated strategies in the previous example.

DISPLAY 9: HIGH-CONVICTION GROWTH-ORIENTED COMBINATION—SAME RETURN, LESS VOLATILITY

Calendar-Year Relative Returns (Percent)



2004–2014 (Annualized)	Relative Return	Tracking Error
Growth	1.7%	6.6%
Dividend Yield	1.5	3.8
Quality	1.3	5.2
Growth-Oriented Combination	1.6	2.9

Past performance is not a guarantee of future results.

Through December 31, 2014

Growth-oriented combination contains equally weighted growth, dividend yield and quality high-conviction portfolios, rebalanced monthly. Using data from Style Research, high-conviction strategies are defined as the top 20% of managers who consistently display a high-conviction characteristic in the eVestment US Large Cap Equity universe. Performance shown is for the 30th-percentile manager in each high-conviction strategy universe from 2004 to 2014. These numbers do not represent the performance history of any AB-managed product. For further details, please see methodology notes in the Appendix.

Source: eVestment, S&P, Style Research and AB

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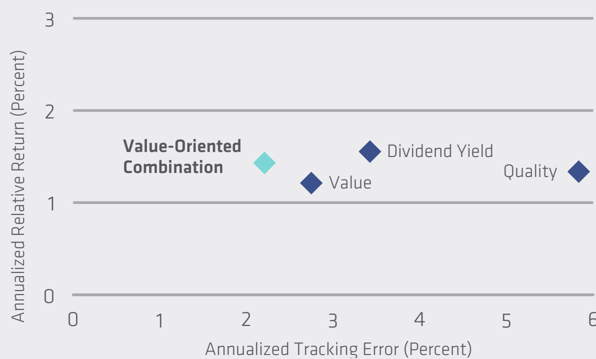
Passive and active combinations can be very effective.

CONVICTION COMBINATIONS: VALUE WITH DIVERSIFICATION

Value investing is a very attractive proposition to many investors who seek to capture the power of undervalued stocks mired in controversy. However, this approach requires patience and is prone to severe bouts of turbulence, which can be unsettling in the short term.

DISPLAY 10: HIGH-CONVICTION VALUE-ORIENTED COMBINATION

Equally Weighted Value, Dividend-Yield and Quality High-Conviction Portfolios



Past performance is not a guarantee of future results.
As of December 31, 2014
Using data from Style Research, high-conviction strategies are defined as the top 20% of managers who consistently display a high-conviction characteristic in the eVestment US Large Cap Equity universe. Performance shown is for the 30th-percentile manager in each high-conviction strategy universe from 2004 to 2014. For further details, please see methodology notes in the Appendix.
Source: eVestment, S&P, Style Research and AB

In this example, we fused a high-conviction value portfolio with a quality strategy and a dividend-yield strategy in equal parts. During the 11-year period studied, the relative return of the combined portfolio was similar to the returns of the individual strategies—but tracking error was reduced from 2.8% to about 2.2% (*Display 10*). Similar results can be achieved by combining a value strategy with low-beta and momentum strategies.

CONVICTION COMBINATIONS: ACTIVE AND PASSIVE

While risk tolerance is personal, every investor is attuned to reducing risk and managing volatility today. In recent years, heavy fund flows into passive portfolios have reflected the growing belief that active managers cannot reliably outperform. While it's true that even skilled active managers will not outperform every year, many have demonstrated an ability to do so over time.

But going passive isn't risk free. By choosing a purely passive approach, an investor will forgo any potential for additional returns in an era when market performance is likely to be subdued. While passive portfolios may address concerns about relative risk, they won't help an investor mitigate absolute risk when markets decline. Passive portfolios may also leave investors exposed to market bubbles and distortions that active strategies can circumvent.

There is also a middle ground. By combining passive and high-conviction portfolios with diversifying characteristics, investors can reduce tracking error substantially from the purely active option, while also enjoying better returns than the benchmark (*Display 11*). For example, creating a growth allocation that is 55% passive and 45% active would cut tracking error by more than half, to 3%, from

DISPLAY 11: RISK REDUCTION CAN BE ACHIEVED IN MULTIPLE WAYS

Combinations of High-Conviction and Passive Portfolios to Achieve 3% Tracking Error

	% Passive	% Active	Relative Return†
Growth	55	45	0.83
All Active Growth-Oriented Combination	0	100*	1.64

Past performance is not a guarantee of future results.
As of December 31, 2014
Using data from Style Research, high-conviction strategies are defined as the top 20% of managers who consistently display a high-conviction characteristic in the eVestment US Large Cap Equity universe. Performance shown is for the 30th-percentile manager in each high-conviction strategy universe. For further details, please see methodology notes in the Appendix. The S&P 500 is used as the passive index with monthly rebalancing to the stated target. No transaction costs were considered.
*All active growth-oriented combination is one-third growth, one-third quality and one-third dividend yield.
† Versus S&P 500, January 2004–December 2014
Source: eVestment, S&P, Style Research and AB

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6.6% for a 100% active growth strategy (as shown in Display 9), while still delivering above-benchmark returns. Similar results can be achieved with different mixes of active and passive allocations with a dividend yield or quality approach. And an all-active mix with a growth-oriented combination could actually create an allocation with a similar risk profile but higher returns.

Of course, there are many things to consider before choosing the right approach for individual needs. For example, fee budgets may determine how much is available to allocate to active strategies. Yet there is a trade-off between the additional cost of fees for skilled high-conviction active managers and the risk reduction achieved in cheaper, passive portfolios. In Display 11, the all-active combination delivered an annualized return of about 1.6% more than the S&P 500—about twice the return of the active growth and passive combination. In other words, the all-active combination delivered an 81-basis-point advantage, which should be compared to the incremental fees of having a 55% greater allocation to active managers.

Additional considerations include an investor's philosophy about different approaches to the markets. And manager selection risk adds additional uncertainty. If you can identify an active manager who is capable of consistently beating the benchmark after fees, then we believe it's preferable to stay active and forgo passive strategies. But armed with an understanding of how passive and active approaches work together, investors can address the many considerations related to manager selection with the right mix of strategies.

EMPOWERING EQUITY INVESTORS

Equity investors today face a blinding array of choices—and an equally wide range of dilemmas. Should you channel increasing portions of an equity allocation toward passive solutions? What's the best way to ensure that an active manager is likely to succeed? How can you plan appropriately for an extended period of relatively low returns from all asset classes—and still meet your long-term objectives?

To make an equity allocation work harder, the portfolios that you pick matter. We believe that combining different high-conviction strategies, or combining active and passive strategies, can help investors ensure that money spent on active management is deployed effectively—and appropriately—for their individual goals.

High-conviction equity strategies offer many benefits. They're the best expression of manager skill, which leads to better outperformance and strong, long-term equity returns. They can complement passive portfolios and reduce overall risk. And high-conviction strategies can be tailored to achieve a variety of equity outcomes, including downside protection, upside capture or more consistent alpha through changing market environments.

There's no single prescription for how to put together active equity allocations. But by understanding how different high-conviction strategies work, investors can be empowered with the information to stay active in ways that deliver better results and peace of mind through the long journey toward investing success.

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APPENDIX

METHODOLOGY NOTES: HOW ARE WE DEFINING HIGH CONVICTION?

Time Frame: January 2004–June 2014

Universe: eVestment US Large Cap Managers with at least three years of year-end Style Research data (holdings) and AUM >$100 million for at least one quarter (total universe of managers: 1,122).

Definition of High-Conviction Universe and Manager: For each manager's history, 60% of year-ends must be in the top quintile of exposure in a category for that year. A manager may be classified in more than one category (managers in at least one high-conviction category: 707).

Calculations of Skilled High-Conviction Manager Returns: Skilled managers are managers who have above-median returns within their category during their entire reporting period. Each month, all the skilled managers in a high-conviction category are used to compute the average return, with outlier returns capped at the fifth percentile. Monthly average returns are then linked to compute the skilled high-conviction manager return.

HIGH-CONVICTION EXPOSURE BY CATEGORY FOR JUNE 2014

Past performance is not a guarantee of future results.
As of June 30, 2014
Source: eVestment, Style Research and AB

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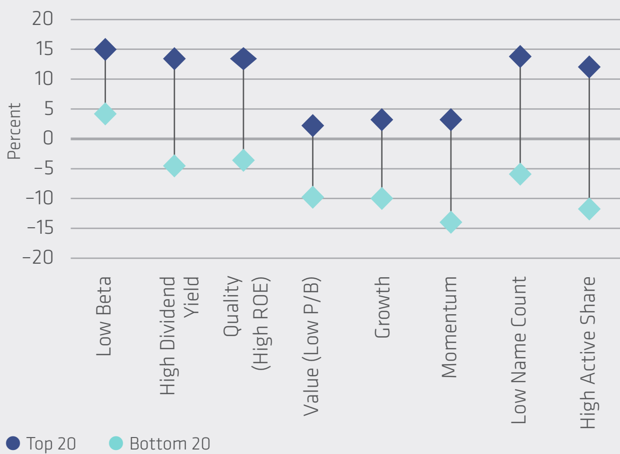
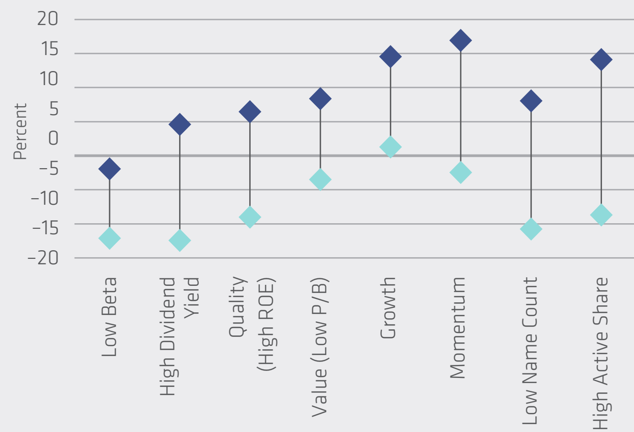
RANGE OF RELATIVE RETURNS OF US LARGE-CAP HIGH-CONVICTION MANAGERS

2004–2014

In Down Months (S&P 500 Annualized Average: –44%)



In Up Months (S&P 500 Annualized Average: +54%)



Past performance is not a guarantee of future results.

Through December 31, 2014

Return dispersion showing the average return of the managers in the top 20% of performance and the managers in the bottom 20% of performance in down months and then up months by high-conviction category. Monthly outlier returns are capped at the fifth percentile. The average annualized numbers are based on the average of the monthly returns in the worst third and best third of all months surveyed. In the worst third, the average monthly return was –3.7%. In the best third, the average monthly return was 4.5%.

Source: eVestment, S&P, Style Research and AB

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