November 2017

Conviction with consistency

Investing the Alphinity way

The last few years have seen a notable increase in a focus on the value of active management and a rise in the popularity of passive and thematic-based Exchange Traded Fund investing as a lower cost alternative, coinciding with the regulatory fee requirements for trustees required to offer low fee solutions.

A behavioural response of this industry change has seen active fund managers incrementally taking on additional active risk to justify their fee. Variation away from the traditional market cap benchmark in the form of high active share can be increased in the form of higher concentration in the number of stocks, large sector tilts, unconstrained cash positions and, holding companies which have different risk profiles to the benchmark and becoming 'benchmark unaware'.

The following will explore this issue and share some techniques Alphinity use to construct a high conviction portfolio with a reasonable level of active share (60%) and that, in Alphinity's view, doesn't take on unnecessary active risk. This leads to delivering a more consistent level of alpha (outperformance of the benchmark from active stock selection) generation over time. In summary, we will discuss:

- knowing **when** to take risk is more important that simply increasing active risk;
- consistency in alpha generation prevents behavioural biases; and
- techniques in stock picking to ensure a consistent level of alpha generation.

Why risk is relevant when constructing a portfolio

A portfolio is generally measured against a performance benchmark. Even if this benchmark is an absolute return objective, it is always important to measure how much intra-period volatility is experienced to generate outperformance of your objective.

Increasing active share in the form of concentration in a portfolio can result in extremely differentiated short-term returns. However, the increased risk through benchmark differentiation can lead to greater drawdowns and prolonged periods of underperformance. It is important to be careful not to confuse risk for returns. Yes, we need to take some risk to get returns, but sometimes risk just equals risk, without accompanying returns.

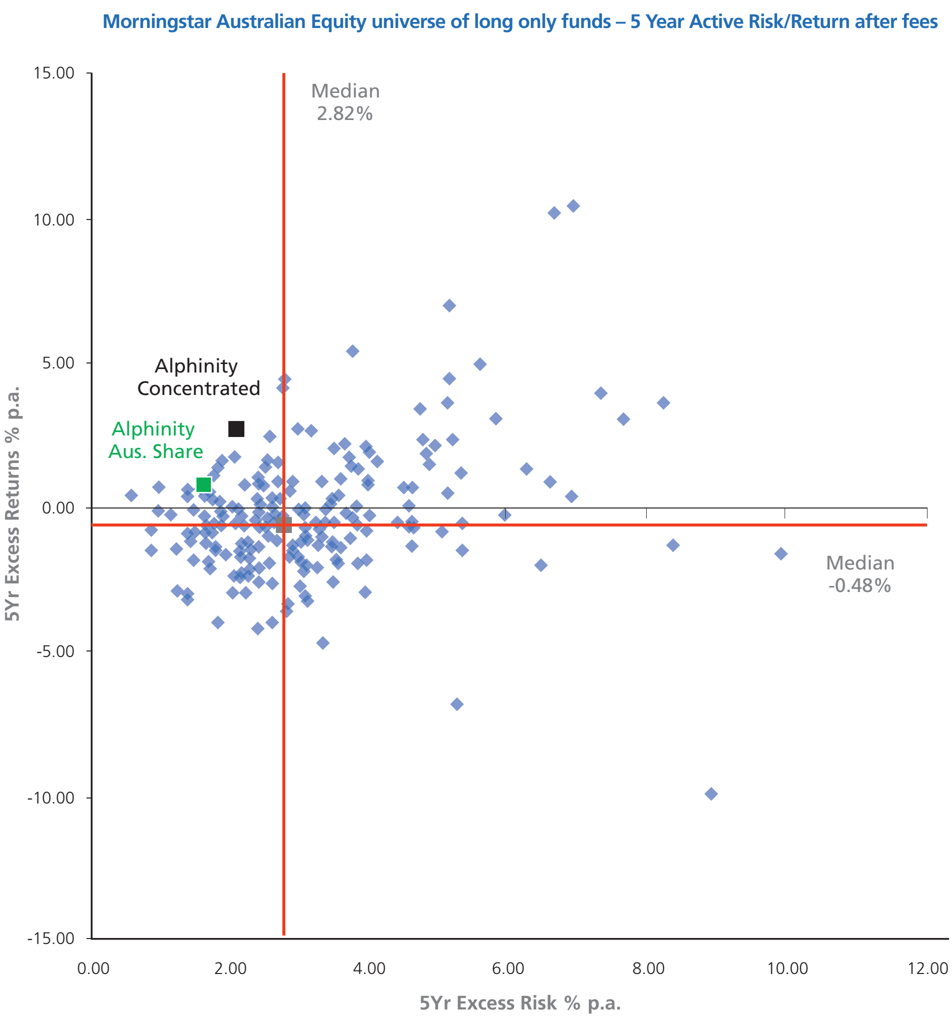
An example of active risk and return outcomes is displayed in Figure 1. This snapshot is taken using the Morningstar universe of Australian Equity Long Only managers' performance and active risk (tracking error) at the end of June 2017 (after fees). Funds are ranked by Active Return (y axis) and level of active risk (tracking error (x axis)).

There are a couple of notable points from this chart.

1. The median manager in Australia has marginally underperformed after fees over the last five years.
2. As the level of active risk/volatility increases, (x axis), so does the dispersion of returns.
3. Outside a handful of outliers, there does not appear to be a huge benefit for the increase in risk taken beyond the median.
4. Funds that sit in the top left quartile will have a far superior risk adjusted return than their peers.

It is possible to increase active share and therefore risk in a portfolio, without significantly increasing in tracking error or volatility of returns. A fund that can balance the higher returns expected of a more concentrated portfolio, without significantly increasing the level of active risk is ideal. These are generally the funds in the top left hand quadrant in Figure 1. Research published by an independent research house Cambridge Associates (2015) confirmed this. They state in their report *Constructing Superior Equity Portfolios* (2015) that "the combination of high active share, high concentration and modest tracking error had the greatest power to predict superior returns".

Figure 1: Active Risk vs Active return of the Australian Share Long Only Universe



Source: Morningstar

Why is consistency of alpha generation important?

Consistency of alpha generation is important because it:

- prevents behavioural biases associated with buying a star performing manager right at the top of a cycle or losing faith in the approach just at the wrong time;
- is more practical for an adviser managing a large number of clients with multiple entry and exit points; and
- increases the likelihood of positive active returns over the long term.

The philosophy and approach that an investor uses when picking companies to construct a portfolio can often influence the path an investor's portfolio will take to its destination.

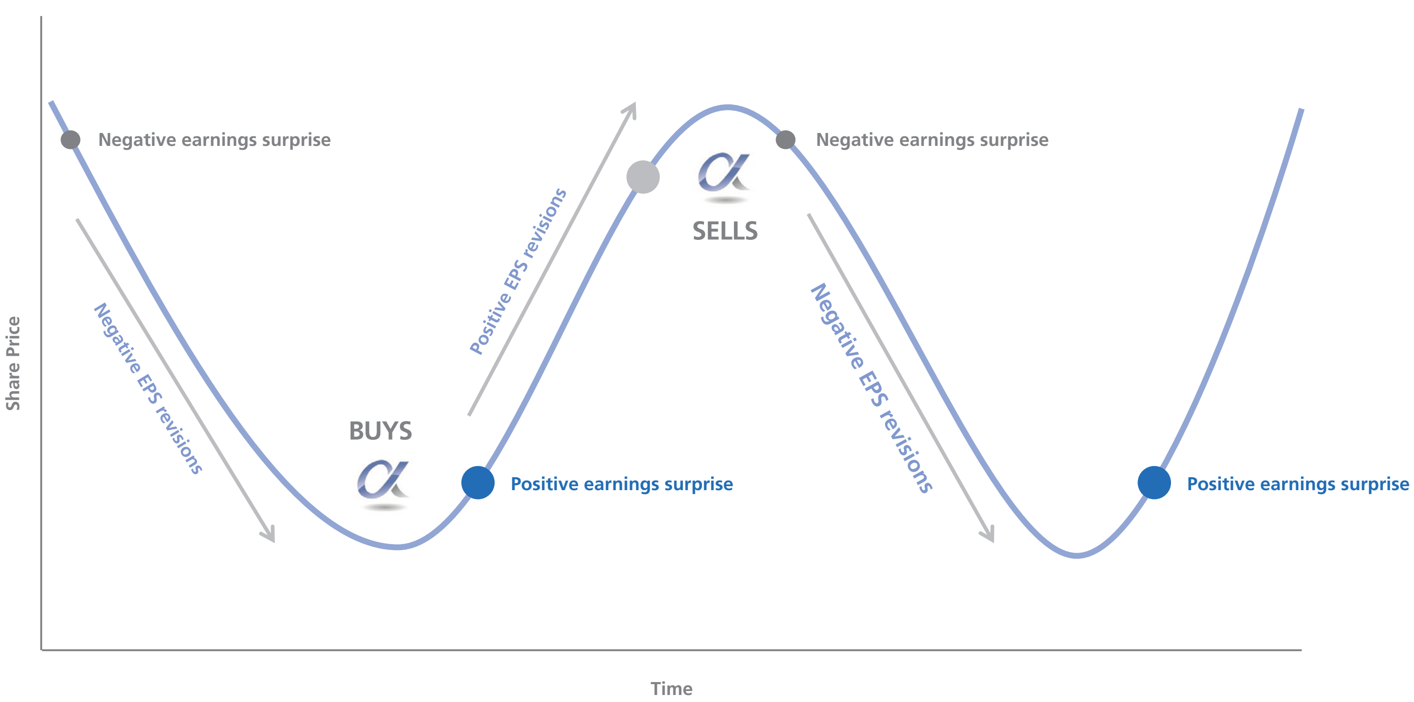
Employing strong style biases in a process will lead to much more volatility over time without any guarantee that you will achieve a better outcome. If a manager uses a contrarian/deep value approach for example, this style can often be out of favour for extended periods (many years). When the cycle eventually turns, returns may be large assuming the manager stuck to their convictions over those long periods, but timing is highly uncertain and returns are very lumpy in nature.

At Alphinity our approach when selecting stocks is specifically designed to deliver a more consistent, repeatable alpha over time. In other words, not taking unnecessary risk to achieve our objective. The key in a portfolio management sense is far less about how much risk you are taking at any point in time and more about **knowing when to take that risk.** You can take as much risk as anyone else just make sure you only do it at the right time, and as importantly, take that risk down or out when you have no advantage. Figure 2 below shows the point in the company earnings life cycle Alphinity is most likely to target.

How do you deliver consistent alpha?

Alphinity believes it is possible to deliver more consistent alpha over time by knowing when to invest in a company's earnings life cycle. We look for companies in an earnings upgrade cycle. As earnings revisions and share prices are highly correlated, when a company is in a period of consistently revising earnings higher and consistently beating market expectations this leads to share price outperformance. Earnings upgrades (or downgrades) tend to be correlated, in other words you rarely see just one upgrade – they are usually followed by several more. This is the trend we are looking for.

Figure 2: Typical earnings and share price cycle



Source: Alphinity Investment Management

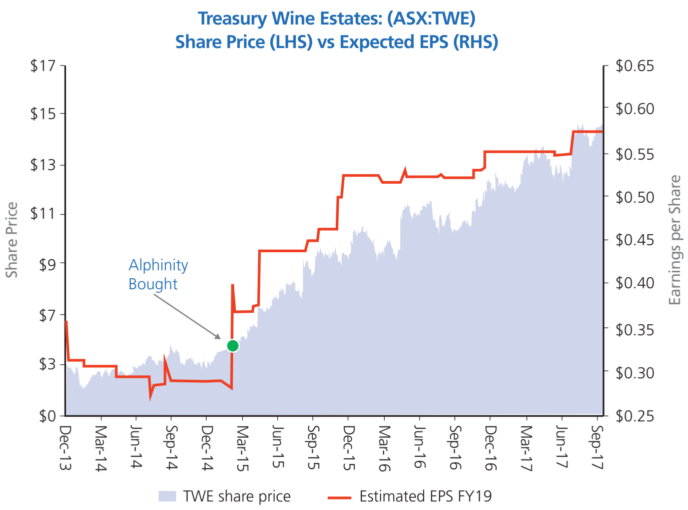
Alphinity INVESTMENT MANAGEMENT

The sweet spot in the earnings upgrade cycle

Investing using earnings revisions is not without risk. Alphinity seeks to control this risk when managing a concentrated portfolio by implementing strict buy and sell disciplines and focussing on what we believe to be quality companies. Alphinity aims not to buy too early and wait for an earnings surprise to avoid value traps. Equally important using valuation indicators is the way to avoid being caught in a growth trap. If a company issues a downgrade to earnings this, in our view, is generally a strong indicator to sell the company.

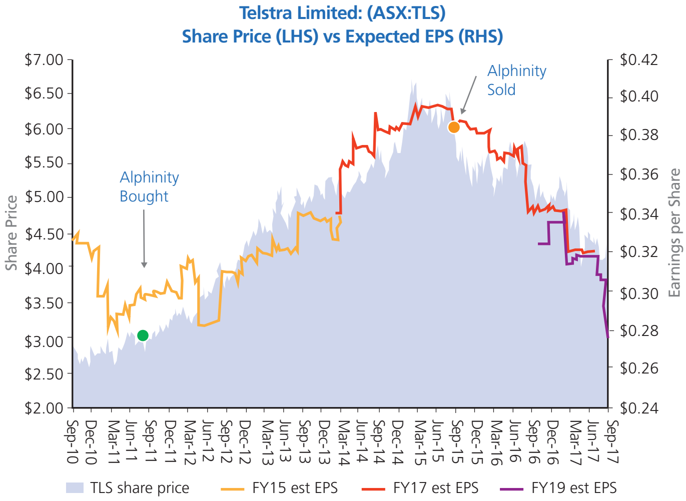
Recent examples of companies in an upgrade Treasury Wine Estates (ASX: TWE) and downgrade cycle (Telstra ASX: TLS) are displayed in Figures 3 and 4. These charts show the clear correlation between earnings revisions and share price. The charts also show that when there is one upgrade/downgrade, there is an increased likelihood of another. This is due to the behavioural bias of both company management and market analysts who are slow to fully price in the future implications of today's new information.

Figure 3: Share price vs consensus earnings estimates



Source: Bloomberg

Figure 4: Share price vs consensus earnings estimates



Source: Bloomberg

Diversify your portfolio

Although a concentrated portfolio holds fewer stocks, it is important to maintain a level of diversification to protect from prolonged periods of underperformance or a rapid change in sectoral sentiment like we saw in resource stocks in February 2016. Even in concentrated portfolios you need to ensure you haven't also concentrated your risks into just one or two thematic or variables. You still want to have a portfolio of investments not just a huge tilt to one factor. Holding an appropriate level of diversification helps manage the active risk and volatility in the portfolio, despite the higher active share.

In summary

The Alphinity Concentrated Australian Share Fund has produced a high level of consistency in delivering alpha over the last 7 years in the Australian market. This has been achieved by using our disciplined, repeatable approach of seeking quality, undervalued companies in an earnings upgrade cycle. By seeking to control the risk around the beginning and end of these cycles, it can be possible to reduce the potential volatility around company turning points or the end of an earnings growth cycle. It may not as exciting be as some other higher risk strategies in the short term, but could mean you arrive at your desired destination with a smoother ride and with more certainty.

Want more information?

To find out more about the Alphinity Concentrated Australian Share Fund, contact your local Fidante Partners BDM or call Adviser Services on 1800 195 853.

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