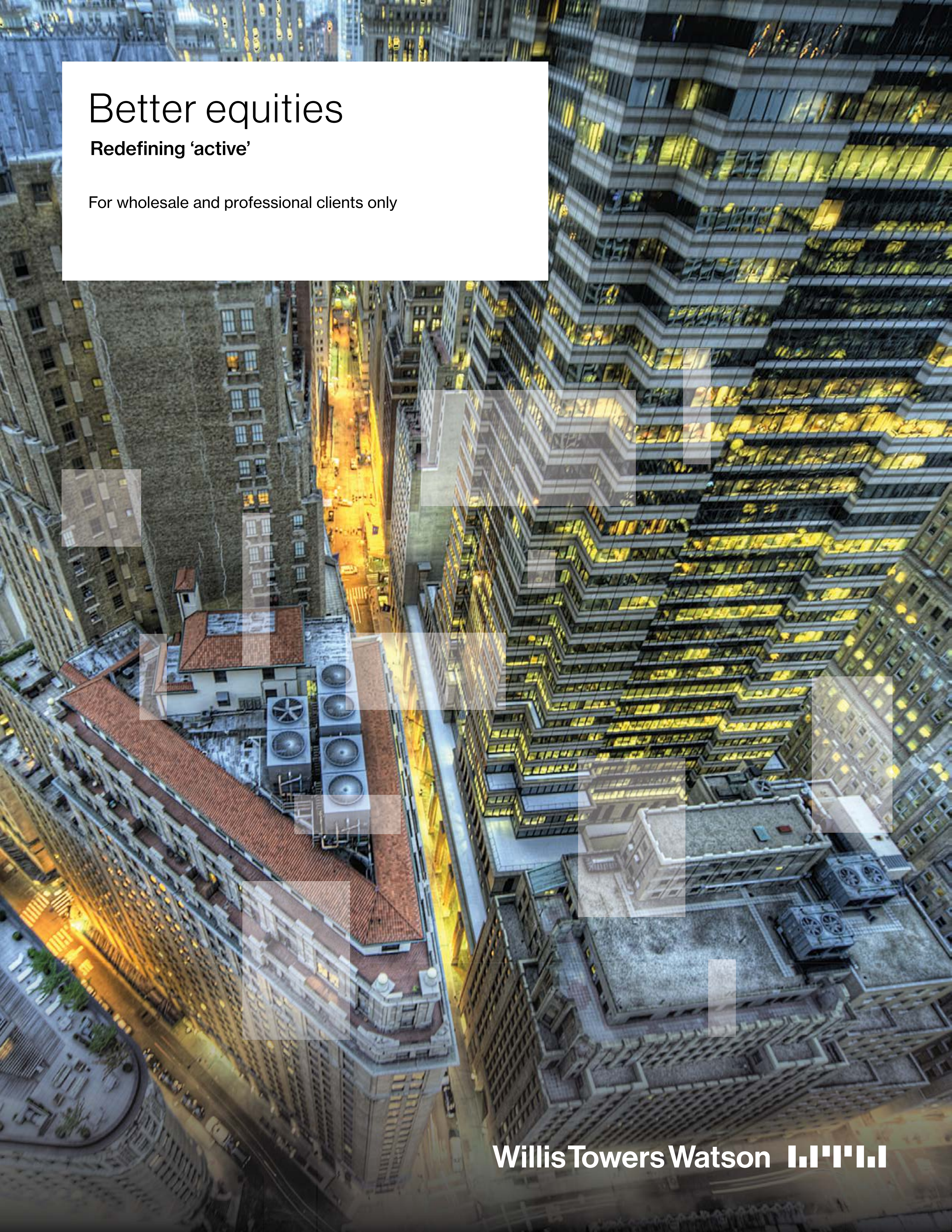
# Better equities

**Redefining 'active'**

For wholesale and professional clients only



Willis Towers Watson

Look to increase your return potential – we believe focused, high-conviction equity portfolios are more likely to outperform after fees in the long run.

Seek to increase your odds of achieving those returns – diversify across lots of managers that have complementary approaches.

Achieve this at potentially no extra cost than traditional approaches.

# Better equities

## Introduction

Most active equity strategies underperform. Market trends show investors are losing faith in active management and moving to passive strategies*. In some ways this trend is rational given many active equity strategies have over-diversified portfolios with high fees – the odds of long-term success are very low.

However, in a market environment of low expected returns from beta, we believe investors are more in need than ever of active management. So what is to be done? Repeating the same active management approach hoping for better results is an unappealing option. A new approach is required: one that will seek to improve expected returns and, importantly, the likelihood of delivering on those expectations.

In a low return environment it is also all the more important that returns are not dwindled away by high fees. The good news is that, for those in a good negotiating position, compelling value for money opportunities are available from active managers.

## The new approach: how to build a better equity portfolio

Here we explain how we achieve each of the key investor needs.

Figure 1. **What do investors need from their equity investments?**

| Investor need | What we have done |
| --- | --- |
| **1. Maximise the long-term returns** | **Designed products with greater potential to add value** |
| **2. Minimise the risk of underperformance** | **Improved portfolio construction approach focusing on greater diversity** |
| **3. Low cost** | **Driven down all costs and expenses** |

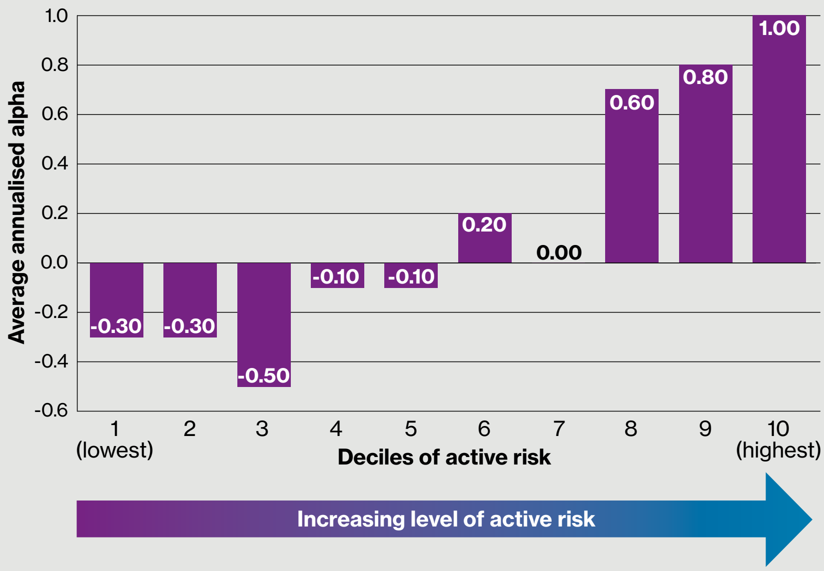
## 1. Maximise long-term returns

Legendary investor Sir John Templeton put it simply: “If you want to have better performance than the crowd, you must do things differently from the crowd.” If the crowd is represented by the market then active fund managers need to be building portfolios that differ substantially from the broad market. A useful measure for this is ‘active share’. There is substantial academic research on the performance of active managers that suggests a reliable link between active share and long-term success in equity investing, as shown below.

- **Brands, Brown and Gallaher** wrote in their 2005 paper, “More concentrated funds outperform. Abnormal performance is generated by bets made at the stock level within industries rather than at industry or sector level.”
- **Kacperczyk, Sialm and Zheng** wrote in 2005, “We find that more concentrated funds perform better after adjusting for risk and style differences using the four-factor model of Carhart (1997).”
- **Jiang, Verbeek and Wang** wrote in 2013, “Managers’ highest-conviction stock holdings outperform.”
- **Petajisto** wrote in his 2013 paper, “High active share managers outperform. Active stock pickers that take large but diversified positions away from the index do best.”

*Source: https://www.bloomberg.com/news/articles/2018-12-31/shift-from-active-to-passive-approaches-tipping-point-in-2019

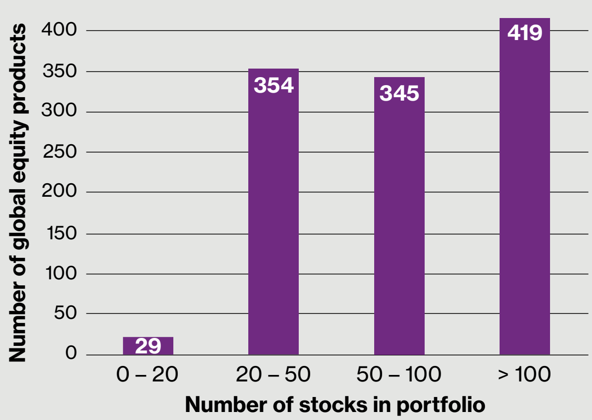
Figure 2. **Excess returns by level of active risk**




[1]Source: Sebastian and Attaluri, "Conviction in Equity Investing", 2014.

Sebastian and Attaluri's 2014 paper "Conviction in equity investing" provided the chart in *Figure 2* which shows the alpha generated by portfolios split by decile of active risk. The indication is that products with higher active share are better able to overcome fees and deliver superior returns over time.

Figure 3. **Relationship between products and number of stocks held**




[2]Source: eVestment, Willis Towers Watson. Data as at 30 June 2019. The "Universe" is the eVestment 'All Global Equity' universe.

In the face of this evidence, you would assume that many active products on the market are highly different to the benchmark. Unfortunately, this is not the case. *Figure 3* shows the number of global equity products in the eVestment database, split by number of stocks in the portfolio which is a rough proxy for active share.

The reason behind this discrepancy is the potential 'excessive' underperformance against the benchmark in the short term.

To avoid this bumpy ride – which can be intolerable for many clients – managers will often include 'fillers' in their portfolio: lower conviction positions to make the portfolio more like the benchmark, dampening relative risk whilst decreasing active share. This vicious cycle leads to sub-optimal equity portfolios that are doomed to (almost always) fail.

Our response to this is simple. We are in the process of mandating our preferred equity managers, handpicked by our dedicated equity manager research team, to create products that reflect only their highest-conviction investment ideas, disregarding short-term underperformance. This is not a trivial mandate. Just as we need to build comfort with the managers, the managers have to build confidence in us. In the long term, however, our data points suggest the highest probability of achieving alpha.

## 2. Minimise the risk of underperformance

Building a product that guarantees success or which continuously outperforms will, unfortunately, never be possible. But we aim to put in place an approach that maximises the probability of long-term success and significantly reduces the risk of material underperformance over a reasonable investment horizon.

### *Diversity*

When hiring one manager, dependency on that manager for long-term success is a one-sided bet. However, combining lots of uncorrelated managers provides far more diversity of thought, research process and decision making, thus increasing the odds of success over the long term. *Figure 4* illustrates the likely benefits of a multi-manager approach.

Unfortunately, only sophisticated asset owners have the governance required to hire and monitor the appropriate number of managers. So in general, the vast majority of active equity portfolios lack sufficient diversity and underperform.

*Figure 4a* shows how the probability of suffering different levels of underperformance, at some point within a 10-year period, changes with different numbers of managers. As we have said, the higher expected long-term returns from a single concentrated portfolio comes with potential for more short-term underperformance along the way. Hiring multiple uncorrelated managers may reduce this risk. When using traditional, more diversified products, the probability of a very material drawdown is largely mitigated with the use of around four to five managers. However, with concentrated products, eight or more managers is generally needed.

Another way to insulate the portfolio against substantial underperformance risk is to apply an additional risk management overlay to address unintended risks.

Figure 4. **Probability of underperformance**

*For Illustrative Purposes only*

Figure 4a. **Traditional products**

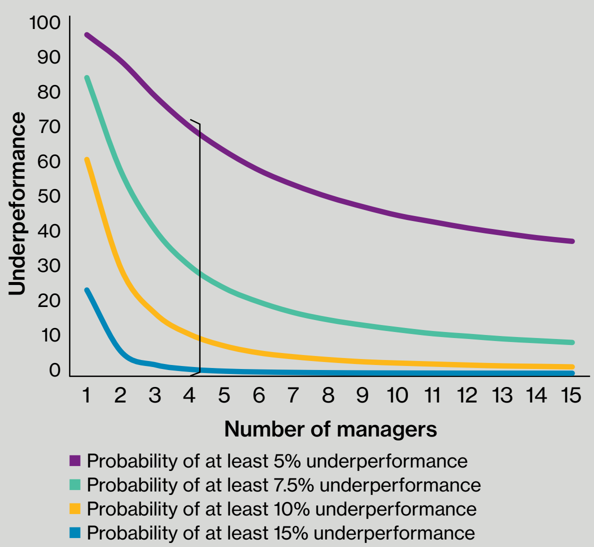
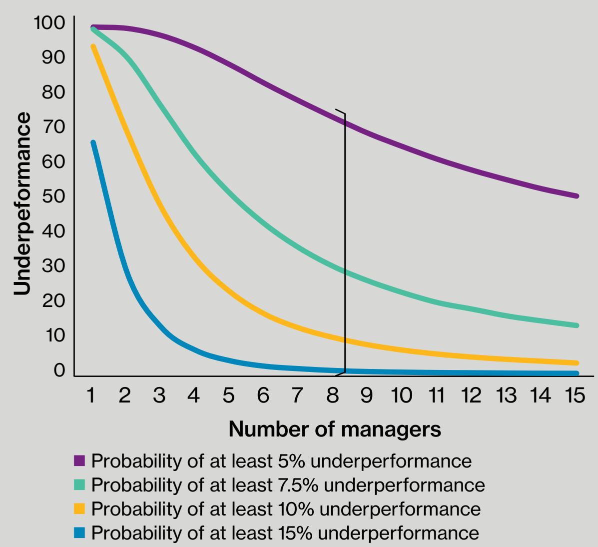



Figure 4b. **Concentrated products**




Source: Willis Towers Watson. As at 28 February 2017 simulated performance is not a reliable indicator of future returns.

Traditional products – Assumptions: Net Alpha 1.6%, Tracking error 5.0%, NIR 0.32, Average Correlation of Alphas 0.2
Concentrated products – Assumptions: Net Alpha 2.6%, Tracking error 8.0%, NIR 0.325, Average Correlation of Alphas 0.1

Methodology: The probability figures are calculated from the following monte carlo simulation: A 10 year portfolio track record for the stated number of managers is created by sampling monthly returns from a normal distribution that has return and standard deviation as per the assumptions below. The portfolio simulation is repeated 100,000 times and the probability of outperforming the benchmark is calculated as the number of simulations in which the simulated alpha was greater than zero, divided by 100,000. The portfolio assumptions are as follows:
Traditional managers: Outperformance net of fees is 1.6%pa, tracking error 5%pa. Average Correlation of Alphas between managers = 0.2
Concentrated managers: Outperformance net of fees is 2.6%pa, tracking error 8%pa. Average Correlation of Alphas between managers = 0.1

*Figure 4b* provides another way of looking at the benefits of using multiple managers. Evidence from a study of our manager ratings shows that picking one of our higher-rated global equity products would have delivered around 70% probability of the return being above 0%. However, if you randomly selected 10 of our highest-rated products, the probability of outperformance rises to 95% and the chance of underperforming decreases.

## 3. Low cost

Costs add up to represent a significant drag on long-term results. Management fees are the most obvious element. Larger asset pools offering long-term relationships with managers are potentially able to negotiate very substantial discounts on standard market rates.

Beyond headline fees, other expenses add up unless there is careful cost control:

**Transaction costs** – By selecting and committing to managers with long-term investment horizons that typically have low turnover, transaction costs are kept naturally low.

**Tax leakage** – Tax inefficient vehicles can lead to leakage. This will vary on a case-by-case basis but can be a significant amount (of the order of 20 to 40 bps).

**Additional expenses (for example, custody administration)** – A few basis points can be saved through better management of other operating costs, particularly for those controlling larger asset pools.

## 4. Summary

Industry trends are showing that the status quo of active equity is not delivering. At the same time, we believe investors are in great need of added returns from manager skill due to an environment of expected low return. Getting the best from active management is not easy; to generate potential better returns than the crowd means going beyond typical approaches to manager selection. Our proposal is to meet investor needs by:

- Increasing expected returns through opportunistically engaging with managers to come up with bespoke concentrated portfolios
- Improving the stability of those returns through improved diversity
- Delivering this at low cost through driving down all associated costs in the food chain

### Willis Towers Watson's equity investing beliefs

- Most attempts to outperform equity markets will fail. It is not easy. A differentiated approach and genuine skill are required.
- Genuinely skilled managers exist – we invest significant time and effort in identifying them.
- High active share and concentrated portfolios are advantageous; academic research supports this.
- Our expectations of success rise when investors engage with investment managers to deliver better outcomes.
- Portfolios are more robust when they are diversified across many managers with different approaches and specialisms.
- A broad opportunity set can be accessed through unrestricted global mandates.
- Contrarian portfolio management can add to long-term returns. Investors should be willing to add capital to underperforming managers and take it away from strong outperformers.
- Costs matter. We seek to deliver value for money by using our scale to reduce costs and using our influence with managers to create bespoke, cost-effective products.

## For more information

For further information on better equities, contact your Willis Towers Watson consultant or:

**Leslie Mao, CFA**
Head of Equity Research, Australia
leslie.mao@willistowerswatson.com

## Reference

[1]Sebastian and Attaluri's 2014 paper "Conviction in equity investing".

[2]Source: eVestment, Willis Towers Watson. Data as at 30 June 2019. The "Universe" is the eVestment 'All Global Equity' universe.

[3] Methodology for traditional products: The probability figures are calculated from the following Monte Carlo simulation: A portfolio track record for the stated time period is created by sampling monthly returns from a normal distribution that has return and standard deviation as per the assumptions below. The portfolio simulation is repeated 100,000 times and the probability of outperforming the benchmark is calculated as the number of simulations in which the simulated alpha was greater than zero, divided by 100,000. The portfolio assumptions are as follows:

Single skilled manager: outperformance net of fees is 1% pa.

Tracking error is 5% pa.

Ten skilled managers: each simulated manager is independent, with outperformance net of fees of 1% and tracking error 5%.

Correlation of managers = 0.

[4]Methodology for concentrated products: The probability figures are calculated from the following Monte Carlo simulation: A portfolio track record for the stated time period is created by sampling monthly returns from a normal distribution that has return and standard deviation as per the assumptions shown under each chart. The portfolio simulation is repeated 100,000 times. The probability of exceeding various levels of underperformance is calculated as the number of simulations in which the underperformance threshold was exceeded, divided by 100,000.

Underperformance is defined as peak to trough cumulative, not annualised.

[5] The figure shows the distribution of five-year returns relative to the MSCI World from randomly selecting a certain number of preferred global equity products. A portfolio of the stated number of randomly selected products is chosen and the average five-year excess return of the portfolio is calculated. This is repeated 1,000 times and the distribution of the portfolio's five-year excess returns is shown. The list of preferred (previously FREX 1) products is as at 30 June 2016 and performance data for each product is the five-year performance relative to the manager's stated benchmark, gross of fees, for the five years to 30 June 2016, where available. There were 23 preferred products with five years of performance data.

## About Willis Towers Watson

Willis Towers Watson (NASDAQ: WLTW) is a leading global advisory, broking and solutions company that helps clients around the world turn risk into a path for growth. With roots dating to 1828, Willis Towers Watson has over 45,000 employees serving more than 140 countries and markets. We design and deliver solutions that manage risk, optimise benefits, cultivate talent, and expand the power of capital to protect and strengthen institutions and individuals. Our unique perspective allows us to see the critical intersections between talent, assets and ideas – the dynamic formula that drives business performance. Together, we unlock potential. Learn more at willistowerswatson.com.



willistowerswatson.com/social-media



willistowerswatson.com

Willis Towers Watson