The PODfolio Podcast Episode 17: Asset Class Mini-Series: Equities

STUART GRAY: So that's one problem facing passive investors, where they're trying not to take stock specific views, but they're starting to rely now, on a small number of stocks, a lot more.

SPEAKER: Welcome to the PODfolio, Willis Towers Watson's investment podcast series, where we'll give you an update on the latest developments across global markets, and talk to expert guests on hot topics that matter to institutional investors and their portfolios.

LOK MA: Hello and welcome to The PODfolio podcast. I'm your host, Lok Ma. This episode is the first in a new mini series we're doing, taking a more in-depth look at different asset classes and the things that investors should be thinking about for 2021. Now, the most natural place to start is, of course, equities as a vital return seeking asset in most portfolios. And I'm delighted to welcome today, two of our portfolio managers with a focus on equities. We've got Heidi Liling, who is based in Australia. So I think it's good evening to you.

HEIDI LILING: Good evening, Lok. I'm excited to be here for my first ever podcast experience.

LOK MA: Wow. I hope we're giving you the experience you're looking for, Heidi. And we've also got Stuart Gray, who like me, is based in the UK. So in this case, it's good morning to you Stu.

STUART GRAY: Good morning to you, Lok. Pleasure to be here.

LOK MA: So we're focusing on the equity markets today. Obviously, we've just been through a pretty remarkable period, including the fastest market fall and recovery in history when a pandemic first struck, and then probably against most, if not all expectations, this continued rise in the market since then up until now, when the S&P, for example, is sitting at an all time high. So what on Earth is happening? Does it make sense to you, Heidi, that markets are apparently in a better position than before we ever heard of this thing called COVID-19?

HEIDI LILING: Overall, I personally think yes. It does broadly make sense. And I can go into that in a moment, particularly around the level of stimulus and support from governments around the world. But first, I would just say that I do agree with the more emotional side of things, in that if you told me a year ago that markets would be where they are today, I would have probably disagreed.

And I don't want to go off on a tangent, but I will.

LOK MA: That's all right.

HEIDI LILING: Funnily enough, a few of us in my team in Australia, we did play a little game, and when the market crashed last year, we each gave predictions for what we thought would then play out over the rest of 2020.

And of course, not surprisingly, we were all very wrong, particularly around the strength of the market recovery. So what I want to say, is that the recovery has been a lot stronger than most people would have predicted, which we should remember as a very natural feeling, especially through a period when all of us are still impacted day to day, in some way, by what we should remember as the health driven crisis. People are dying, and it's natural to feel strange that markets have recovered while cases around the world have grown drastically over the same period.

In saying this, I also don't think any of us predicted the level of stimulus. Being that support from governments, pumping unprecedented amounts of money into economies, and lowering interest rates across the world. This has really helped that broad recovery of markets. And also the stimulus doesn't seem to be ending any time soon.

Finally Lok, I might just add that it's important to also remember that COVID has created a lot of dislocation in the market. There's been a lot of structural change across industries, and these things actually create a lot of opportunities. So that's big growth potential coming out of COVID as vaccines are rolled out, economies open up and work towards going back to normal, or what their new normal is.

LOK MA: So we're saying at least, in part, that it's the money being pumped in by the government that's pushing up the prices. So this came up in our last episode, introducing our Outlook 2021 paper, when we talked about this potential for higher returns in the near term from all of this stimulus money. But possibly, relatively lower returns, over the longer term as we have to pay off the stimulus essentially. So turning to you now, Stu. For equity investments, would you agree with this view that returns might be in some way front loaded?

STUART GRAY: I think, yeah. There's some element of truth to that. So clearly, The stimulus is designed to get the economy going and really stimulate activity. So that those prices can continue to rise in the near term. This front and loaded point, I think-- Heidi mentioned some of the growth companies that have benefited. So there are companies that have really benefited from the shift to online, driven by the pandemic.

So in these cases, where you've got lower interest rates, the stimulus has driven down interest rates. So a lower discount rate means you're valuing longer term cash flows into the future, more highly. So these growth companies that can continue to grow for long periods of time, are certainly more valuable today because of that fact.

So really, what your valuations today mean, is you're relying on that growth rate being delivered. And you're relying on it materializing over quite a long horizon into the future now. So any risk around that could weigh on prices, but I think the market today is saying they do think that these companies are delivering growth. The shift online is permanent and growing. So the market is saying that these growth rates are justifiable, and the valuations are justifiable, as a result.

LOK MA: And of course, as we're recording this, there's been quite a few stories in the news around equity investments that made the headlines recently. Heidi, do your clients pay attention to these kind of topical news stories, or do they tend to think that these could be relevant to them as well?

HEIDI LILING: Yes, definitely. And that's a very interesting question. I think three of the biggest things on investors' minds at the moment are probably, firstly valuations. So what Stu was talking about. Given everything that's happened, it's natural for investors to wonder where valuations will go to from here.

Secondly, what's quite topical at the moment and particularly interesting as well, is some of the conversations around the behavioral aspects of markets. So things like GameStop and market manipulation, retail money. So smaller investors investing more and more and making up a larger proportion of markets more recently.

And then also, the very strong performance of mega-cap stocks. So stocks such as Amazon and Google, which have contributed most to the rise in the markets over the last year. Thirdly, just more generally, investors are definitely wondering whether they should be doing anything differently in the equity portfolio, given the events of last year, and given everything going on in markets at the moment.

LOK MA: So you mentioned GameStop, Heidi, which I think a particularly kind of juicy story. So it's been presented as a bit of a David versus Goliath battle. Can you just quickly explain what happened, and then also, whether you think this could actually start a new trend, changes the way the markets operate.
HEIDI LILING: Sure. So I'll quickly explain what happened recently, and then I can talk about your question on whether this changes the way markets operate. In terms of what happened, essentially GameStop is a video retailer. So they have many physical stores, and therefore had been struggling largely due to COVID. There are a number of hedge funds that basically bet against the company. So they were looking to make money if GameStop shares fell in value. This is what we call, short selling.
It happens all the time. It's not actually that big a deal usually. But what actually happened in this case was, users in a Reddit forum decided to collectively buy shares in GameStop. Essentially to drive the price up, with many doing this as an act against the idea of bigger institutions making money off a struggling company. And these individuals were successful in driving the price up significantly, which did succeed in causing losses for the hedge funds that had bet against the stock.
In terms of your second question, Lok, around whether this will change the way markets operate. I personally think, no, not really. Market manipulation is something that has happened many times throughout history in various ways, and will continue to happen in the future. In saying this, it definitely was interesting to witness and it does show the power of group thinking and speculation and the internet. But no I don't think it ultimately will change the way markets operate.
LOK MA: And by the way, Heidi, I know this story has been hailed as a victory for the little people, but isn't it actually true that at least some of those who put their own money in to artificially drive up their share price in GameStop, they're probably going to lose out in the end, right?
HEIDI LILING: Yeah, definitely. And it's quite ironic, because as you say, there would have been many individual investors who got involved either because of Reddit, or just because everyone else did. And they would have been investing as the stock price was rising in value, only to then have the price crash, because of course, the price was essentially artificial. And they would now be sitting on losses.
LOK MA: So-- yeah, go on, Stu.
STUART GRAY: I was going to say, I think it worth adding that the short squeezes that we've seen in GameStop, and the various options, elements of what was happening. These are bread and butter things for most hedge funds. They're not new concepts in terms of short squeezes and so on. I think as ever in markets, there's always adaptation.
Things happen that you need to adapt for in processes. So I think we will see some of that evolution in how long-short managers think about their short positions, for example. But I agree with Heidi. In terms of structural change with how markets operate, I don't see this as being dramatically different.
LOK MA: So moving on a bit then from retailers versus short-sellers, to a more age-old debate, I guess. I know the old active versus passive question has been done to death, but we, as a firm, generally think that the good active managers can add value. But I also think that there are different times that are particularly good or not so good for the active managers to outperform. So Stu, what sort of time are we in at the moment?
STUART GRAY: It's interesting. There's a few points in here. So I think, right now, we're at a time when we're starting to talk about the pressures and challenges facing passive investors, maybe for a change. But just to cover off, let's do the active-passive in 20 seconds. I think active in theory is better. If you can expect higher returns for roughly the same amount of risk, that generally is a better strategy.

The problem is that in reality, and in practice, those higher expected returns don't materialize. And most people underperform net of costs over the very long term. So in practice, it's better for a lot of people to be passive. So where this active-passive debate really gets to is, how confident are you that you have got skill and competitive advantage in active management? If you have skill and competitive advantage, then you should be doing active.

But of course, most people don't have that. So when it comes to-- so those are structural issues. Those are time insensitive. But when it comes to your point around, where are we today, I think passive investors have got some things to think about. Because the goal really with passive is to say, look, I don't have competitive advantage in picking companies. I'm just going to own all the companies and harvest the equity risk premium over long periods of time.

So one of the things happening today, as Heidi mentioned earlier actually, is a concentration in the market that's come about from these large tech firms doing so well in the last few years. So now concentration is higher, I think than it's ever been. So that is meaning that your passive portfolio is not really as diverse as it once was. And I think in 2020, about half of the returns of the MSCI All Country index came from just five companies.

So that's one problem facing passive investors, where they're trying not to take stock specific views, but they're starting to rely now, on a small number of stocks, a lot more. And the second part of this is sustainability. And this is obviously a big topic. But basically, it's saying the world is changing very significantly and very dramatically.

And just harvesting the equity risk premium over time may be a little bit more challenged, because how they apply that risk premium, may change significantly as sustainability thinking comes into people's focus. So I think those are the two key reasons why passive investors, I think, need to think about whether that is the best strategy or whether active might make sense today.

LOK MA: OK, so you know we think that the good active managers can outperform. But it's also true that across the whole market, lots of active investors will still underperform the index once you knock off the fees charged by the active managers. So Heidi, do you have a perspective on this one?

HEIDI LILING: Yes. I think that's definitely true. And it's certainly difficult to, both choose good managers, but then also to combine them into a portfolio that's diversified enough to appropriately manage risks, but also outperform the index, particularly after fees. And it's actually quite timely that you asked me this question, because I'm working on something at the moment that looks to analyze the performance of large Australian investors, primarily the universe of superannuation funds, so asset owners, in terms of their global equity portfolios.

And the initial results of this analysis are pretty outstanding. It actually shows that on an after-fees, and an after-tax basis, around 75% of these Australian investors have underperformed just a simple global equity benchmark. And that's over the last 10 years. So that's a pretty big number over a fairly long period of time.

STUART GRAY: So I think that happens in Australia. That's great data out of Australia, but I think some other studies have shown reasonably similar numbers. So Heidi mentioned 75%. 75, 80% seems to be about the number that comes up most places around the world now.

HEIDI LILING: It's great.

LOK MA: If you think how hard it is to actually outperform across the market. I mean, what do you think are the reasons for that? What makes it so hard to actually beat the index?

HEIDI LILING: So there are many potential reasons for the underperformance, and it's actually something we'll address when we write up our paper on our analysis. And it's definitely not just specific to Australian investors. But it includes things like, familiarity and home bias. So within global equities in particular, a lot of investors constrain themselves to the big names that they know have a presence in their home country. And that can often mean cutting out a bunch of the investment universe, and therefore not diversifying enough, and exposing your portfolio to unintended biases. In addition to this, and just a general lack of appropriate diversification in portfolios, other reasons may be too high fees or governance structures, and potentially too high turnover. So firing and hiring managers too quickly, which also incurs a lot of transaction costs.

And finally, I might just finish by saying that, while active management can really add value in global equities, you do really need to know what you're doing and have the resources, to both help you pick a number of skilled but different or diversified managers, and also then use this to construct a robust portfolio that appropriately manage risks, and hopefully outperforms after-fees over time.

LOK MA: So knowing what you're doing, having the right resources. I think this quite neatly brings me onto talking about governance. So as an institutional investor, how do you go about trying to pick the right managers? So from what Heidi said, having one active manager, probably not enough, because you're very much dependent on their performance. But equally, I imagine having too many active managers means you're either overlapping your positions, or even canceling each other out in some way. So where's the sweet spot? What's the right number of managers for you?

HEIDI LILING: So that's a good question. It depends on a few things. But overall, when picking managers, and I'm talking here about for a global equity portfolio, what you really want is a number of skilled managers with different views and approaches. So both in terms of their philosophy, and also in terms of things like style. So growth, value, quality. You want some of everything.

in terms of the right number of managers, to achieve an appropriate level of diversification, our work indicates around eight to 12 managers is the right number. But there are a few things I would say on this. So firstly, in order to be able to identify these skilled managers, what is really important, particularly since you touched on governance, is appropriate resourcing and expertise.

And a global research team is in particular, valuable in the global equity investing space. I might also just add that we really think what can add value, is actually asking each of these different skilled managers to run concentrated portfolios of only their best ideas. So 10 to 15 stocks. And this is because of course, what you really do want is access to the ideas that managers have the most conviction in.

And then, when you combine these eight to 12 portfolios of each manager's different best ideas, what you get is a total global equity portfolio of about 150 stocks, that's diversified enough such that the total portfolio risk is managed appropriately. And therefore, what you're really targeting then is the stock picking skill of the underlying managers, which hopefully makes it easy to outperform the index. And this is approach that we've used to manage money for our clients for quite some time now, and we've been very successful in doing this.

LOK MA: So thank you for that, Heidi. Sorry, Stu, did you want to add to that?

STUART GRAY: Yeah, I was just going to maybe step back a little bit from this and just say, that number of managers is talked about a lot, but this really does-- this whole conversation comes down to, what is your skill in active equity management? And how do you outline the approach that we might use and the

skills that we think we have? But if you go back out to the industry again, let's just say in round numbers, there are something like 15,000 equity products in the world that you might want to use.

And Heidi said, 75, 80% of these underperform. So you're left with maybe 2,000, 3,000 perhaps, that might outperform the index over time. So in theory, if you pick those 2,000 products, you can have a 2,000 product portfolio that outperforms. So it is not purely down to the number of products you use. But it is down to your competitor advantages, down to your skills, and how you put portfolios together.

So as Heidi described, institutional investors tend to put together a number of managers. And it has to be a manageable number for you to be able to apply your skill across these number of managers. But actually building that portfolio is critical. And your question's right, Lok. A lot of people don't build portfolios very well, end up with lots of overlapping positions that cancel each other out and end up with index.

Heidi described a different way of doing things, using concentrated portfolios with better diversity, and creating a portfolio that still has a lot of alpha potential within it. So it really comes down to, what are your competitive advantages? Not only in managed selection, stock selection, but also portfolio construction.

LOK MA: So Stu, you mentioned a reasonable number of active equity managers. I think Heidi, you actually said, somewhere in the region of eight to 12. How do you feel about re-balancing your allocation across these managers from time to time? Because arguably, if you re-balance, you're taking money away from the successful one and giving it to the less successful one. Or should you not re-balance and just let the successful one keep more of your assets?

STUART GRAY: Yeah, this is a tough one Lok, because both philosophies do exist and have some rationale to it. So in all honesty, there's not a perfect answer to this, I'm afraid. Some people argue for running your winners, cutting your losers. I think re-balancing probably makes most sense in the long run, in the context of what we're talking about here. Because if we think we're skilled at picking managers, and can build a multi-manager portfolio, then at the outset you believe that all of these managers are going to outperform handsomely in the long term.

Now, we know that the reality is that we don't get 100% of decisions correct. So not all of those will outperform. The problem is, we don't in advance which ones. So when managers inevitably go through performance cycles, there's always cycles and elements in the market which cause outperformance and underperformance in the short term.

Some sort of structured approach to re-balancing is probably sensible over time, unless you are really confident about which are the best managers, and which are not the best managers out of the ones you've chosen. And that's a very difficult thing to do. So we think a sensible approach to re-balancing, to capture some of the short term volatility, with the expectation that all of these managers should outperform in the long run.

LOK MA: And now, one of the other things you mentioned at the beginning of this episode, Stu, was around sustainability. I think you mentioned it at a very high level. But I think it's such a big theme that's going to be running across all of our different chats on the different asset classes. Can you just also give us your take on sustainability, please, in the context of equity investments.

STUART GRAY: Yeah, well as you say Lok, it is a really big topic. So I undoubtedly won't cover everything here at all. But I think when it comes to equity investing, integration really is key. And I say this in a very simplistic way, because equity-- the value of a company is really the present value of all the future cash flows and profitability of that business, all the way out into the future, which is why equities have infinite upside.

Now when you're thinking with that kind of time horizon, you just have to think about these issues when you're valuing a business. It's impossible not to. So if we're talking about who is a skilled investor, someone who's thinking about investing in a company without understanding some of these sustainability issues, i.e. what might happen to this company's customer base if they find out there's some issues in its supply chain around child labor, for example.

Or what happens in their competitive position in the industry if they're using a very inefficient process, or using too much energy, and they're not doing anything about it. That's a higher cost. So there are some very basic things that you just have to think about when you're investing in companies for the long term.

So from my perspective, this is all about integration of how you assess the risks and opportunities facing businesses. Weirdly, I think the industry as a whole-- I say weirdly. It's important, but the industry has called out ESG as a separate thing, and then said you have to integrate it. And I find that a bit weird, because it almost separated it out, to then tell people to integrate it back in.

Now I think that's necessary, because you really have to raise people's awareness of this issue. So you do have to call it out. But I think that has caused problems. But whenever we're looking at long term investing, integration of all the sustainability analysis is critical to skilled investors today.

LOK MA: Thank you. Thank you, Stu. Before we go, maybe if you don't mind, Stu, wrapping this up for us in terms of, if there's one thing that equity investors should be thinking about next and what would you recommend that to be.

STUART GRAY: Sure. Well, one thing we haven't talked about too much is some of the behavioral aspects of investing. But I would just observe that we're seeing so many extremes now in the world today. Extremes in climate, extremes in politics, extremes in equity markets, in other asset classes. It is very challenging. And a lot of investors are confused and struggling with this level of bifurcation and extremes that we're seeing everywhere.

We've talked a lot about the challenges facing passive investors. And I think those are very real today. So I think it's important for investors to think about how to invest today, going forward, given the starting point of high market concentration, high levels of bifurcation in the market, high degree of uncertainty. Incredible change in the long term coming from sustainability.

How do you deal with these things? Very difficult questions, but I think active management has a real role to play in that. And of course, as we said right at the start, if you're going down the active management route, thinking about what is your skill and do you have competitive advantage and skill here. And if you don't, how do you get it? Who can you work with to help harness that kind of skill. So I think those are the real things that I want investors to be thinking about today in equity markets.

LOK MA: Great. And thank you very much for coming on to talk to us. Heidi, thanks so much for coming on.

HEIDI LILING: Thanks very much for having me, Lok.

LOK MA: And Stu, thanks very much to you, as well.

STUART GRAY: Thanks, Lok. It's been a pleasure. So as I said, this was just part one of our new asset class miniseries. And the next episode, I think, is going to be looking at bond investments. So thanks for listening, and do take care until then.

SPEAKER: You've been listening to a Willis Towers Watson podcast. For more information, visit willistowerswatson.com.