Absolute conviction, at what price?

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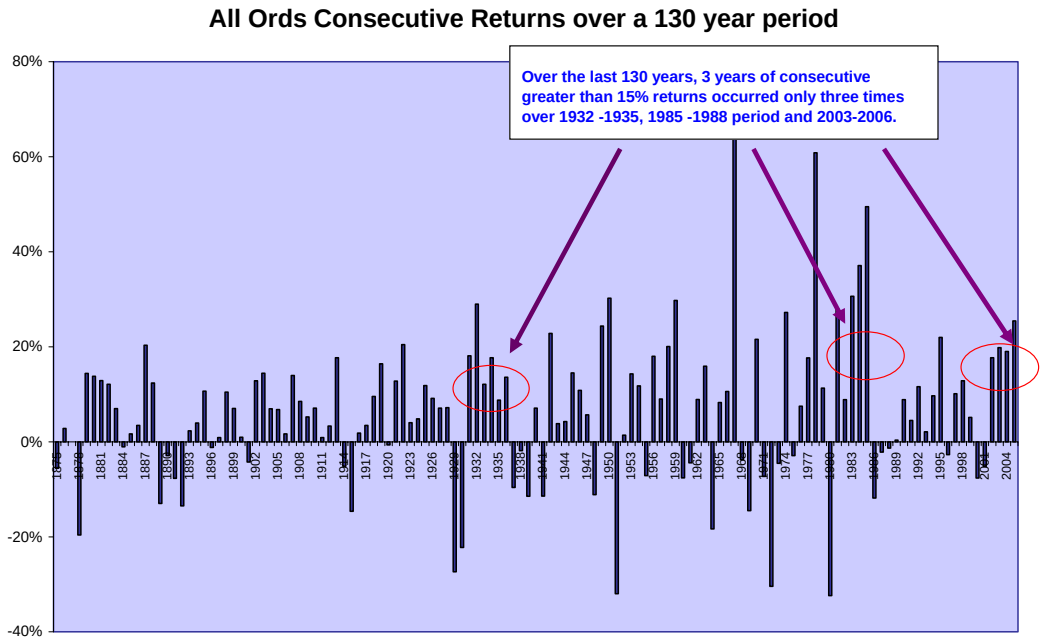
Summary

When equity markets start generating returns significantly above long term averages, risk has a tendency to be mispriced. What are the consequences for high conviction absolute value managers when risk is eventually repriced? Do they necessarily attract more risk and is this risk permanent or passing? Is diversification a benefit or handicap? This paper examines the benefits of concentrated portfolio management and the value that an absolute return focus adds to this strategy. In doing so, it addresses issues such as risk (loss of capital versus standard deviation), diversification and argues the benefits that a concentrated absolute value based fund can bring to an investor's overall portfolio.

With the current bull market well into its 5th year, it's worth taking a step back to examine the investment backdrop. Over the last 130 years there have been only 2 other periods similar to the current environment, 1932-37 post the Great Depression / pre WWII and 1983-87 in the lead up to the October 1987 stock market crash. This is illustrated in Figure 1 below.

Figure 1: Long term performance of the All Ordinaries Index



Source: IRESS, MMC Asset Management

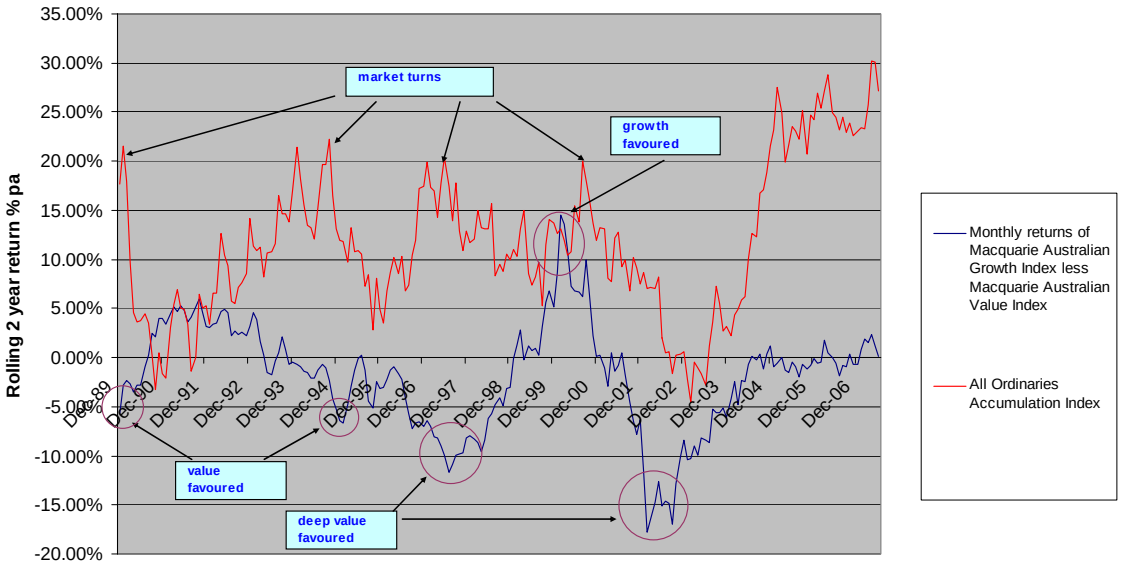
There are signs of an overheated market including record numbers of IPOs each year, high liquidity with cheap debt, increasing participation of hedge funds, rampant M&A activity and the ever present premiums

private equity are paying [1]. Risk premiums are contracting on the back of 15 years of economic growth and a relatively stable rate environment, suiting momentum investing and pricing absolute value managers out of the market. Investors are expecting higher returns with lower levels of risk than long term averages would suggest are achievable. Yet it is inevitable that the market will eventually mean revert and risk will ultimately be re-priced.

Value managers – when do they outperform?

We examined the relative performance of the Macquarie Australian Value and Growth Style Indices and superimposed these against the All Ordinaries Accumulation Index. This is illustrated in Figure 2.

Figure 2: Relative performance of growth versus value styles over rolling 2 year periods.



Source: Macquarie Equities, IRESS, MMC Asset Management

It is noteworthy that value has shown a strong tendency to outperform when markets turn, with a significant outperformance during the last bear market of 2001/2002 in the aftermath of the tech crash. During periods where markets perform well, the results are less conclusive with neither style significantly outperforming over the current bull market, although growth outperformed during the previous bull market in the lead up to the 2000 tech bubble.

Supporting the findings in Figure 2, empirical evidence has concluded that the value style of investing outperforms other styles over the course of the economic cycle [2, 3], however, this outperformance is at its greatest during periods of economic and financial market contraction. [4]

What is high conviction investing?

High conviction investing involves holding a concentrated portfolio of 30-40 stocks [5], which represents the manager's 'best ideas'. The manager will focus a large amount of time and effort researching stocks with the result being a high level of knowledge and conviction in the relatively small number of stocks in the

portfolio. These stocks will have high expected rates of return and hence the manager typically invests 2.5-4.5% of the portfolio in these stocks [6].

What it isn't

Much of the appeal of high conviction investing is the high degree of active management. The manager is free to select stocks which maximise the expected return of the portfolio and is not expected to refer to the benchmark or hold 100's of stocks. The manager is also not expected to have a broad knowledge about each stock in the benchmark, but rather to focus heavily on the stocks in which they've invested. The ultimate aim is to allow the manager to do what they do best, i.e. pick stocks. This differs from the objectives of other investment styles such as passive investing, where the aim is to track a benchmark.

What distinguishes the absolute value style?

Absolute value involves investing in stocks that trade at a discount to their intrinsic value. Absolute value managers believe that in the long term, when the operating performance of a business is superior to its quoted valuation, the stock market will at some point acknowledge this with a higher security price. Put simply, an absolute value manager invests in companies whose value according to the share market is considerably less than the manager's appraisal of their fair value. [7]

The discount to intrinsic or fair value is also known as the 'margin of safety', which is effectively the absolute value manager's measurement of risk and return. [8] The greater the discount to intrinsic value, the higher the margin of safety, the lower the risk and the greater the expected return.

The notion that stocks trade towards intrinsic value over the long term is the key to absolute value managers' success. Markets can and do overshoot and there are times (such as in recent years) where the absolute value style has been out of favour, as we have illustrated above in Figure 2. Alternatively markets can remain depressed for extended periods as attractively priced stocks become cheaper. But over the course of the investment cycle, absolute value managers are rewarded for their conviction. [9]

A point of difference

It is important to note the difference between absolute value and the more commonly found relative value style. Absolute value managers review the value of a stock from a pure bottom-up approach. The only point of reference for valuation is the appraisal of fair value. A relative value manager tends to encompass a wider definition of value. They may also regard a stock as cheap if it is cheaper than another stock in the same industry or the industry average or its historic trading multiple.

Differences between absolute high conviction and traditional managers are highlighted in Figure 3 below.

Figure 3: Characteristics of high conviction absolute value managers compared to traditional managers

Characteristic	Absolute high conviction	Traditional
Number of stocks	30-40	150-200
Stock focus / knowledge	Very high	Medium – high
Benchmark awareness	Very low – low	High - very high
Tracking error	No	Yes
Stock weightings	2.5 - 4.5%	Range +/- benchmark weight
Risk definition	Loss of capital	Volatility
Risk measure	Margin of safety	Standard deviation / variance
Diversification	Low – medium	High - very high
Return driver	Alpha	Beta

Source: MMC Asset Management

Putting it all together

The high conviction absolute value manager is best placed to prosper through the market cycle, not necessarily at any one point in time, although most value becomes apparent at times of poor equity market returns. The high conviction absolute value approach is one which is relatively unconstrained when it comes to portfolio management, as best ideas can be followed without reference to a benchmark. Other managers may be mandated by risk parameters such as maximum tracking error or limits on active weightings of individual stocks. These managers may closely track the benchmark, in which case they would have followed the market up in recent years. Figure 2 illustrates that the current bull market has favoured style neutral managers with high levels of beta, especially over the last 2.5 years. While they have outperformed value managers during this period they will either continue to ride the wave or risk significant capital loss when it breaks.

Risk – in the eye of the beholder

It is a widespread view that risk and volatility go hand in hand 10. This stems from modern portfolio theory which measures risk by calculating the dispersion of a set of stock prices from their mean [11]. Volatility is measured by standard deviation or variance [12]. But as a high conviction absolute value manager would see it, the problem with using standard deviation or variance as a measure of risk is that they calculate the size of changes in a security's value. This takes into account both ‘downside’ risk and ‘upside’ risk. [13] However, the latter is not really a risk at all. A common definition of risk is the chance of loss [14], which when applied to investing refers to the possibility of losing some or all of the original investment ie a loss of capital. With this in mind, a share price that moves several standard deviations above its mean has hardly lost the investor money.

High conviction absolute value managers would take this argument one step further. Since they aim to invest in stocks at a discount to intrinsic value, any decrease in the share price (which may increase volatility) would actually make the investment less risky, all things being equal. For example, a high conviction absolute value manager invests in a stock at a share price of $3 but deems it to have an

intrinsic value of $4. The upside on this investment is 33%. Say the next day the share price drops to $2. All things being equal, there is now 50% upside on this investment and it is less risky because the margin of safety has increased. The high conviction absolute value manager would view this favourably and likely increase exposure to this investment because it has a flexible mandate. Other managers would view this in terms of the increase in volatility, which would lead to the conclusion that the investment has become more risky. Those managers may also be mandated to closely follow a benchmark so that even if they believed the stock looked more attractive at $2, their ability to buy it may be constrained by the (limited) maximum overweight they can take on the stock.

Putting diversification into context

The common argument for diversification stems from modern portfolio theory [15], which distinguishes between systematic and non-systematic risk. The former is the risk associated with the market and cannot be eliminated. However, the latter relates to the inherent risk in owning an individual security, which can theoretically be reduced by holding a diversified portfolio of securities. According to Modern Portfolio Theory, there is no reward for assuming a risk can be diversified away and hence it is better to own every security in the market to eliminate non-systematic risk. [16]

However, the high conviction absolute value manager would beg to differ. Since Modern Portfolio Theory measures risk through standard deviation, reducing standard deviation through the diversification of a portfolio will not necessarily reduce risk as viewed by a high conviction absolute value manager. Given the high conviction absolute value manager's view on risk, the greater diversification may or may not decrease the chance of capital loss.

In addition, the high conviction absolute value manager typically has a portfolio of 30-40 stocks representing their best stock selections in the market. Combining these best ideas with additional stocks in order to diversify the portfolio may simply dilute returns. High conviction absolute value managers have a very strong understanding of the 30-40 stocks they own, where as other managers who maintain 150-200 stock portfolios simply cannot build an equally sound knowledge base on every stock in their portfolio (unless they have a very well resourced investment team). For these managers, diversification is a sound strategy. For the high conviction absolute value manager, diversification is much less of a concern as they focus on profiting from their thorough knowledge base on a limited number of stocks.

Concentrated absolute value as part of an overall portfolio

Since high conviction absolute value managers differ greatly in stock selection methodology and portfolio construction style to traditional managers, their correlation to a benchmark such as the All Ordinaries Accumulation Index should be low. This is demonstrated in Figure 4 below. Hence it would be expected that allocating part of an equities portfolio to a successful high conviction absolute value manager would increase the risk adjusted returns of the portfolio.

The Study [17]

MMC Asset Management conducted a study to test this thesis by obtaining the time series of monthly returns for a high conviction absolute value manager with a successful long term track record. A mean/variance analysis was then performed on a hypothetical Australian equities fund and on a hypothetical balanced fund. The two hypothetical funds were constructed based on benchmark returns (i.e. the All Ordinaries Accumulation Index for the Australian equities fund and, for the balanced fund, a blend of 35% All Ordinaries Accumulation Index, 25% MSCI World Index USD, 10% S&P/ASX 300 Property Trusts Index, 25% UBS Composite Bond Index (0+yr) Maturity and 5% Cash). The risk and return metrics for the 3 strategies are outlined in Figure 4.

Figure 4: Risk and return metrics of the All Ordinaries Accumulation Index, a balanced fund and a high conviction absolute value manager over various long term periods

Metric	All Ordinaries Accumulation Index	High conviction absolute value manager	Balanced Fund (Aust equities 35%, global equities 25%, Aust LPTs 10%, Aust bonds 25%, cash 5%)
10 years			
Return	13.07%	12.63%	8.61%
Risk (standard deviation)	9.79%	8.08%	6.66%
Correlation	1	0.12	0.91
Beta	1	0.10	0.62
Return / Risk	1.34	1.56	1.29
8 years			
Return	14.55%	13.90%	8.66%
Risk (standard deviation)	9.98%	6.05%	6.43%
Correlation	1	0.41	0.92
Beta	1	0.25	0.59
Return / Risk	1.46	2.30	1.35
5 years			
Return	19.56%	14.50%	12.61%
Risk (standard deviation)	8.83%	6.63%	5.85%
Correlation	1	0.52	0.92
Beta	1	0.39	0.61
Return / Risk	2.22	2.19	2.16

Source: IRESS, MMC Asset Management

It can be seen that the high conviction absolute value manager has produced long term returns in line with or marginally lower than the index (due to a large allocation to cash at times when the market was expensive and presented few value opportunities) but with much lower risk. The manager has effectively produced equity market returns for a level of risk akin to bonds (The standard deviation of the UBS Composite Bond Index 10+ Yr Maturity was 7.41% for 10 years, 6.40% for 8 years and 6.02% for 5 years to 30 June 2007). On a risk adjusted basis, the manager's 10 and 8 year track records are superior to the All Ordinaries Accumulation Index. The 5 year performance captures the current 4.25 year bull run, which has been highly unfavourable for this style of management. None the less, risk adjusted returns are still almost in line with the index.

Correlation

The high conviction absolute value manager was then added to the All Ordinaries Accumulation Index with various weightings being ascribed to each. Figure 5 tabulates the correlation between the All Ordinaries Accumulation Index and the high conviction absolute value manager with various weightings being ascribed between the manager's fund and the index.

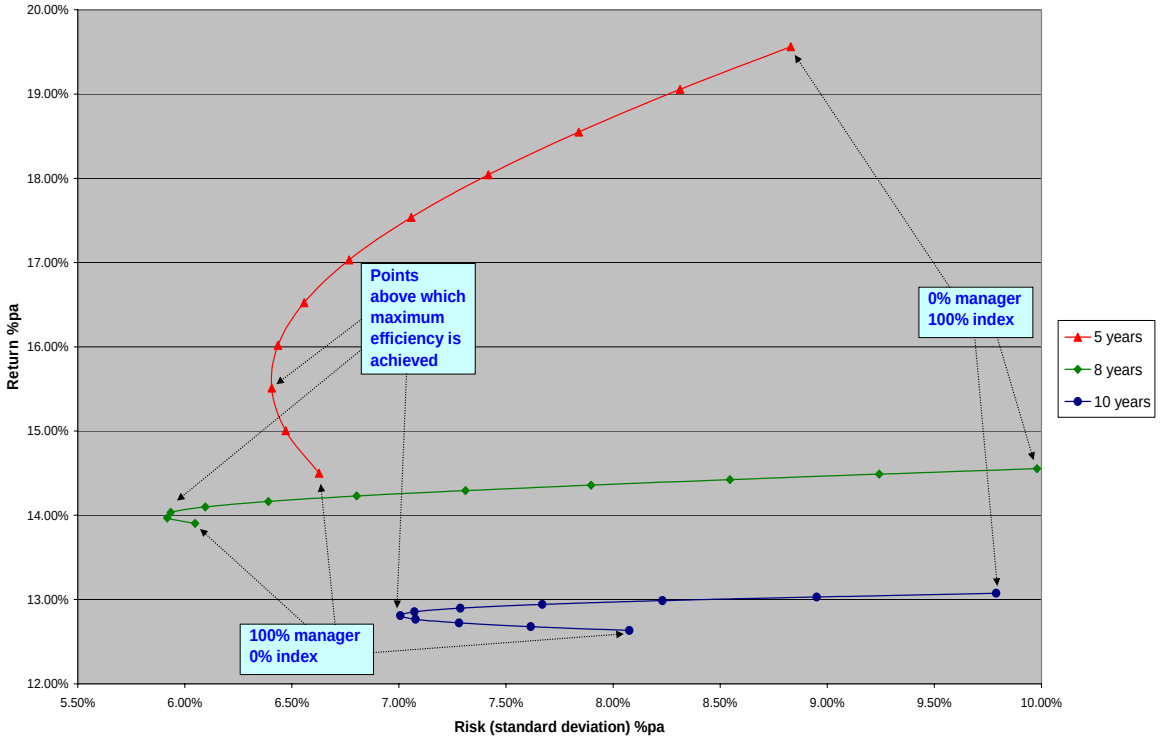
Figure 5: Equities correlation matrix over various time periods

	Index 90% Manager 10%	Index 80% Manager 20%	Index 70% Manager 30%	Index 60% Manager 40%	Index 50% Manager 50%
10 years	0.99	0.98	0.93	0.87	0.77
8 years	1.00	0.99	0.98	0.95	0.91
5 years	1.00	0.99	0.97	0.95	0.91
	Index 40% Manager 60%	Index 30% Manager 70%	Index 20% Manager 80%	Index 10% Manager 90%	Index 0% Manager 100%
10 years	0.64	0.50	0.36	0.24	0.12
8 years	0.85	0.77	0.67	0.54	0.41
5 years	0.86	0.79	0.71	0.62	0.52

Source: MMC Asset Management

As expected, there is a low correlation between the high conviction absolute value manager and the index with a lower correlation for the longer the period under examination. Due to this low correlation, we would expect that the opportunity exists to enhance the risk adjusted returns of the Australian equities portfolio by apportioning some of the portfolio to a high conviction absolute value manager. Figure 6 compares the risk return profile of the fund with 10% incremental weightings being allocated to the manager based on our historical analysis.

Figure 6: Efficient frontier - All Ordinaries Accumulation Index and the high conviction absolute value manager



Source: IRESS, MMC Asset Management

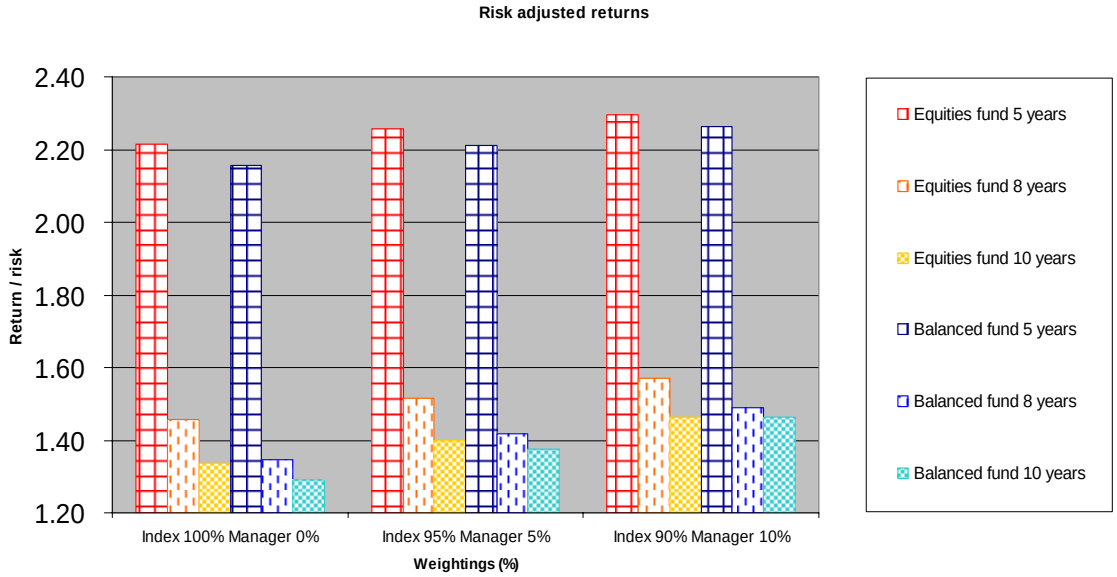
Based on the results depicted in Figure 6, it can be seen that the introduction of a high conviction absolute value manager improved portfolio efficiency by increasing risk adjusted returns. This is particularly pronounced over the 10 year and 8 year periods.

So how much high conviction absolute value is appropriate?

The appropriate allocation of a high conviction absolute value manager to an equities portfolio or balanced fund is a matter of prudence and depends on a number of factors including the investor's appetite for tracking error and exposure to any individual manager. [18] Taking these factors into account, we believe that optimal trade off lies at a 5-10% allocation to a high conviction absolute value manager. For a balanced fund, allocating to a high conviction absolute value manager could replace part of the allocation to Australian equities since the aim is to enhance overall returns without impacting upon strategic asset allocation.

Figure 7 below compares the risk and return outcomes for both the Australian equities and balanced funds with 5% and 10% weightings being allocated to the high conviction absolute value manager based on our historical analysis. For the balanced fund, the allocation to the high conviction absolute value manager replaces the allocation to Australian equities, with other asset classes maintaining constant weightings.

Figure 7: Risk adjusted returns from allocating a high conviction absolute value manager's fund into an Australian equities portfolio and a balanced fund over 10 years, 8 years and 5 years



Source: IRESS, MMC Asset Management

Based on the results depicted in Figure 7, it can be seen that the introduction of a high conviction absolute value manager improved portfolio efficiency by increasing risk adjusted returns over all time periods under examination. Efficiency was maximised when 10% of the portfolio was allocated to the high conviction absolute value manager.

Conclusion

The last 4.5 years have represented a challenging environment for high conviction absolute value managers in the Australian market. Not only have market returns tracked well above historic averages but these returns have been achieved with relatively few bumps in the road. This has led to risk being mispriced as momentum managers have achieved lofty returns. While it cannot be predicted when the current bull run will end, at no point in history has the market achieved 5 years of above 15% returns. Based on this fact, investors can draw their own conclusions as to when the market is likely to turn, but when it does high conviction absolute value managers will be well placed to outperform.

This paper demonstrates that over the course of the cycle, a successful high conviction absolute value manager can outperform the market on a risk adjusted basis. They can do this without generating additional risk in the sense of putting investor capital at risk. While their portfolios undoubtedly lack diversification in the traditional sense, this does not appear to have hindered long term performance. Since they have low correlation with the market, adding a 10% weighting of a high conviction absolute manager's fund into an Australian equities portfolio or a balanced fund should improve the risk adjusted returns of the portfolio over the course of a market cycle, with the greatest benefit occurring when markets turn. This is provided the manager is highly disciplined and committed to the concentrated absolute value style as evidenced by a successful long term track record.

Endnotes

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[14] "risk" *The American Heritage® Dictionary of the English Language, Fourth Edition*. Houghton Mifflin Company, 2004, July 2007.

[15 , 16] Haugen, R. A., "Modern Investment Theory", Pearson Higher Education, 5th edition, 2001, Part II, Ch. 5.

[17] The historical analysis is based on monthly data over the 10 year period ending 30 June 2007. The analysis is based on (a) a hypothetical Australian equities fund comprising a blend of the All Ordinaries Accumulation Index and a high conviction absolute value manager's fund, and (b) a hypothetical balanced fund (comprising a blend of 35% All Ordinaries Accumulation Index, 25% MSCI World Index USD, 10% S&P/ASX 300 Property Trusts Index, 25% UBS Composite Bond Index (0+yr) Maturity and 5% Cash) and a high conviction absolute value manager's fund, and does not represent returns or volatility of any actual fund. Past performance is not an indicator of future performance.

[18] Gunning, P., March 2007, "Maximising returns not risk", *Russell Investment Group*.