# November 2014
# Investment Publications Highlights

## No Fear of Commitment: The Role of High-Conviction Active Management

Laurence B. Siegel and Matthew H. Scanlan, *The Journal of Investing*, Fall 2014

**When constructing a portfolio of managers, investors should consider including high-conviction, or concentrated, managers. Including high-conviction managers can generate alpha and help to achieve a high information ratio at the portfolio level.**

What should the role of high-conviction managers be within an investor's portfolio? Siegel and Scanlan contend that because investors can diversify through the process of manager selection, the underlying managers in a portfolio don't have to diversify. Most managers can and should specialize, making high-conviction managers an attractive and important option for inclusion in an investor's portfolio. The resulting manager portfolio will have large active positions and may also exhibit a fair amount of active risk.

Building a portfolio of broad, diversified active managers might give some investors comfort, but that comfort may be misplaced. One outcome of building a portfolio in this way is that an investor essentially replicates the holdings of an index by holding active managers with many different holdings—ending up with what is in effect a high-cost closet index fund, as many of the active bets would likely cancel each other out. Another outcome, in the event that the investor chose managers whose bets did not negate each other and were instead highly correlated, is a portfolio with a single factor bet and a high associated cost.

The authors' argument to include high-conviction managers in a portfolio is based on the theory of bounded rationality, which asserts that it is more efficient to decide what you can and cannot know than to seek to know everything. When it comes to investing, a wealth of information is available, but it is often difficult to interpret and sometimes impossible to know how much of this information is already priced in to the underlying securities. Investors' rational response should be to identify niche managers with expertise in a particular area or segment of the market. As Siegel and Scanlan state: "Thus, the presence of high-conviction managers in a well-engineered portfolio is a natural consequence of high information costs, limited resources, and the inability of any one individual or small group of individuals to know everything."

In creating a portfolio of active managers, the authors refer to the body of literature supporting the notion that the goal of all investment management is to maximize expected return per unit of total risk, advising investors to seek out managers with the highest information ratios (IR) to ensure that they are compensated adequately for any outsized active risk. Grinold's fundamental law of active management says that the IR is a function of forecasting skill and breadth. For a manager to maintain a high IR, the manager must have either strong forecasting skills or moderate forecasting skills applied to a large breadth of investment opportunities. Concentrated managers focus on the former, while diversified managers tend to focus on the latter. The ideal, but no doubt challenging, scenario to maximize the IR in a multi-manager portfolio is to combine breadth and skill. The authors argue that a manager structure should include both high-conviction and diversified managers, but acknowledge that a diversified portfolio could be achieved using only concentrated managers and need not include diversified managers. The real trick is identifying these "skilled" managers.

Past performance is not an indicator of future results, so while a proven track record is an important quality of skilled managers, investors should also take other factors into consideration. For example, investors should be aware of the professional and educational backgrounds of their managers as well as the continuity of the staff. Investors should have a firm grasp of a manager's investment process and understand what led the firm to believe that its knowledge is overlooked by the market. Successful managers tend to stay aligned with their process over a number of years, so a consistent approach is preferred. Other considerations include the security screening process and the ability of a manager to mitigate unintended risks.

## Conviction in Equity Investing

Mike Sebastian and Sudhakar Attaluri, *The Journal of Portfolio Management*, Summer 2014

**Active management exploits market inefficiencies by acquiring information on mispriced securities in the pursuit of profits (excess return). While evidence points to the existence of active management with some skill, frequently skill produces only enough excess return to cover fees and trading costs. Given fees and trading costs lead to the average active manager underperforming the benchmark, investors must identify the best managers to achieve excess returns from active managers. Sebastian and Attaluri identify conviction as the key to active management success.**

Achieving alpha (aggregate active manager excess returns consistent with portfolio structure, including risk allocation) is challenging, but not impossible. In this article, Sebastian and Attaluri advance the understanding of the track record of active management[1] by conducting an analysis of investment products of institutionally oriented funds. The funds were separated into three categories: unskilled (net alpha<0), no evidence (net alpha=0), skilled (net alpha>0). They found, like previous studies, that the average product underperformed its benchmark, but some outperformed. Roughly 98% of investment products failed to produce excess returns above fees and costs, and that proportion has been steadily rising over time. Given these odds, only the most skilled manager could be expected to outperform consistently.

[1] This article conducts a similar analysis to and builds on work by L. Barras, O. Scaillet, and R. Wermers, "False Discoveries in Mutual Fund Performance: Measuring Luck in Estimated Alphas," *The Journal of Finance*, Vol 65, No. 1 (2010), pp. 179–216.

Their work shows evidence of a link between material active risk,[2] more concentrated portfolios, and outperformance. Sebastian and Attaluri suggest "greater active risk and concentration is a manifestation of conviction, or the willingness to take risk in pursuit of outperformance." Their study illustrates a clearly positive relationship between active risk, alpha, and skill. Managers with low active risk positions to reduce benchmark risk underperform because alpha is reduced by fees and costs. Managers with high active risk tend to outperform and also exhibit a substantial amount of skill. Risk is a necessary condition for achieving alpha. While higher risk alone is not sufficient, it does remove constraints and allow managers that truly have skill to add value.

Sebastian and Attaluri point out that investors' aggregate portfolios are often positioned to earn much less alpha than they expect, even if the active managers they choose are successful. Low-risk strategies, closet indexing by over-diversifying across portfolios, and the combined use of active and passive management all drive down the active risk of the aggregate portfolio. Investors employ passive management to accomplish one of two goals, according to the authors: (1) to reduce the short-term volatility of the active managers in the portfolio, though the drag from too large a passive allocation reduces the chance of success with active management, or (2) to hedge the active management bets in case the managers the investor selected are unskilled, which signals a lack of conviction in active management and is unlikely to be a successful strategy.

[2] Active risk is the volatility of active return versus the benchmark and is also known as tracking error.

Sebastian and Attaluri argue that investors can find significant, lasting success with active management. They recommend investors follow one of two directions for their equity portfolio. For investors lacking the necessary conviction, resources, or risk appetite, they suggest an "efficiency portfolio" that is 100% indexed to a broad global equity benchmark, which benefits from market efficiency and can expect a return equal to or better than the long-term average investor. For investors with high conviction in the value of active management, they strongly recommend an "opportunity portfolio" that is 80% or more actively managed and maximizes the odds of success from active management. Opportunity investors must demand conviction from managers and consultants while taking a long-term approach, showing patience with short-term volatility, and resisting short-term portfolio changes. At a minimum, the authors recommend investors avoid the expensive diversification of investing in numerous low active risk strategies. ■

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