When Every Bip Counts: Building a Capital-Efficient Equity Program

September 2018 | Lori Heinel, CFA, *Deputy Global Chief Investment Officer*

In a moderate-return world, asset owners need to be more mindful than ever of investing their capital efficiently.

For investors who need the growth potential of equities to achieve their long-term investment objectives, constructing a capital-efficient equity program will be a key part of their overall portfolio strategy.

As an industry, we now have a better understanding of the underlying drivers of risk and return and have an array of strategies aimed at capturing the equity risk premium. Our clients often ask for guidance on how to combine the various ways to gain equity exposure across traditional capitalization-weighted indexing, single- or multifactor smart beta, enhanced and higher alpha active strategies. While there is no one-size-fits-all answer, we believe there are some guidelines that can help institutions arrive at an optimal structure for their risk and return objectives.

Tools of the Trade

Having helped global institutional investors of all sizes and objectives for more than 40 years to build efficient portfolios, we believe there are a few principles that will help investors think about the appropriate choices. Our research-driven, systematic approach to investing informs how we think about the potential implementation methods for equities.

We begin with our belief that certain structural factors (technology, demography, globalization) are likely to keep equity returns lower for the next 25 years than they have been for the last 25 years. That means that many asset owners will be unable to achieve their long-term return targets through traditional equity beta or index-based strategies alone. At the other end of the equity spectrum, very large asset owners like sovereign wealth funds or multi-billion dollar pension plans will find it hard to find the necessary scale by relying solely on concentrated active equity strategies.

The Over-diversification Dilemma

Moreover, our Investment Solutions Group has found that many active equity management programs are over-diversified. In other words, our analysis[1] has shown that asset owners who have hired multiple active equity managers (usually around 10 or more) are often deriving limited idiosyncratic alpha and quite a bit of factor premia they could capture in a more cost-efficient way. They are in effect paying high active fees for limited value-add.

Equity Core and Satellite Framework

Most investors will need some thoughtful combination of equity beta and alpha to achieve their objectives. We suggest asset owners focus on building a strong, capital-efficient equity core with a complementary set of alpha drivers (the satellites). The role of the core is to deliver equity beta with all of the attributes that it provides in a broader portfolio context — risk, return, correlation, etc. The satellite strategies are meant to deliver incremental alpha over a predetermined time frame (typically a market cycle) with a high degree of confidence.

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While there is no hard and fast rule about how much of the equity portfolio should be dedicated to the core versus the satellites, we believe a reasonable starting point would be 50/50. This combination may be calibrated based on the size of the overall equity allocation, the asset owner's confidence level in alpha opportunities, fee constraints, short-term risk and tracking-error considerations as well as other constraints and objectives.

Start with a Strong Core

The core part of the portfolio needs to deliver the desired beta exposure, which means that it should generate market-like returns, risk and correlation to other asset classes.

There are several ways to build the core allocation with one or more of the following approaches:

- Traditional capitalization-weighted indexing.
- Enhanced indexing, which retains the appropriate level of risk control to mirror the attributes of a standard index but also provides exposure to targeted factor premia.
- Multifactor smart beta, which can also be managed tightly to the desired index exposure.
- A multi-manager portfolio of complementary active managers might also form the core, but there is limited ability to ensure that this approach will deliver the appropriate risk control and benchmark beta over time.

We believe that the best starting point for a core portfolio is an enhanced indexing approach, given the outlook for modest equity returns, the desire for appropriate beta exposure and risk control, as well as the sensitivities around high active management fees. Given the quantitative nature of enhanced indexing, it is especially appropriate for larger plans that need to scale their core equity exposure.

For asset owners with greater fee sensitivity, who are still interested in generating excess return, a multifactor smart beta approach might also be a good core allocation. This approach has the benefit of transparency regarding the factor drivers of excess return and may be particularly attractive to investors who accept the academic underpinnings of such strategies.

Figure 1: Enhanced Index vs Multifactor Smart Beta Guidelines

Client Consideration	Enhanced Index	Multifactor Smart Beta
Risk Tolerance	**Low tolerance for risk** • Client does not want to deviate meaningfully from the benchmark • Investment process is tightly risk controlled • Low tracking risk: 0.25% to 1.25%	**Higher tolerance for risk** • Benchmark is considered but not tightly tracked • Client is comfortable with higher tracking risk: 3% to 6%
Outperformance Driver	**Proprietary alpha** • Outperformance driven by manager skill • Clients value manager skill and are willing to pay higher fees for it	**Non-proprietary alpha** • Outperformance driven by factor exposures • Factor exposures are not proprietary. Because of this, fees are generally lower
Time Horizon	**Shorter horizon for performance** • Lower tracking risk leads to more consistent alpha pattern • Appropriate for clients who have less tolerance for short-term underperformance	**Longer horizon for performance** • Factors outperform over the long term, but in the short term can be cyclical • Clients should have a higher tolerance for short-term alpha volatility
Transparency	**Non-transparent** • A proprietary research process drives alpha • Managers do not provide full transparency into the portfolio construction process	**Transparent** • Follows a transparent, rules-based process • Because the process is not proprietary, portfolio construction can be disclosed

Source: SSGA

Building the Satellites

As the satellites are meant to deliver excess return, there is a higher tolerance for risk, whether in terms of tracking error, style, concentration, etc. Asset owners will also be expected to pay higher fees to achieve the higher return.

Once again, several approaches can act as effective satellite strategies:

- Traditional active management, either fundamental or quantitative.
- Multifactor or single factor smart beta.
- Enhanced indexing.
- Other alpha strategies, such as tactical asset allocation, long/short equity, and private equity.

As noted, it is important that asset owners analyze their active managers to ensure they are generating true idiosyncratic returns beyond factor premia only. Where multiple active managers in aggregate provide more factor risk than stock-specific risk, we believe asset owners are better served by allocating to a factor-based strategy, whether smart beta or an enhanced strategy. Both of those approaches will provide a more capital-efficient solution to harvesting factor premia rather than paying higher active management fees.

The benefit of using smart beta to replace multiple active managers is that it is highly customizable. Smart beta approaches can involve a single factor or multiple factors, the tracking risk can be calibrated up or down to manage the risk and return characteristics and the smart beta exposures themselves can be managed over time, depending on the asset owner's view of the market opportunity.

Active management of all types (systematic or fundamental) may be used in the satellite depending on the investor's confidence in the strategy's alpha opportunity, the alpha target, fee considerations and risk parameters.

While every asset owner will have unique specifications, we believe equity investors today have a far more versatile toolkit at their disposal for building equity programs that enable a much more efficient deployment of risk and fee budgets.

At a time when every bip counts, asset owners should carefully assess the kinds of equity approaches they want to use to target their risk and return objectives with fees that are properly and transparently aligned to the value added to their portfolios.

[1] Shawn McKay, CFA, Robert Shapiro, CFA, and Ric Thomas, CFA, 2018. "What Free Lunch? The Costs of Overdiversification." *Financial Analysts Journal*, Q1.

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Companies with large market capitalizations go in and out of favor based on market and economic conditions. Larger companies tend to be less volatile than companies with smaller market capitalizations. In exchange for this potentially lower risk, the value of the security may not rise as much as companies with smaller market capitalizations.

A Smart Beta strategy does not seek to replicate the performance of a specified cap-weighted index and as such may underperform such an index. The factors to which a Smart Beta strategy seeks to deliver exposure may themselves undergo cyclical performance. As such, a Smart Beta strategy may underperform the market or other Smart Beta strategies exposed to similar or other targeted factors. In fact, we believe that factor premia accrue over the long term (5-10 years), and investors must keep that long time horizon in mind when investing.

While diversification does not ensure a profit or guarantee against loss, investors in Smart Beta may diversify across a mix of factors to address cyclical changes in factor performance. However, factors may have high or increasing correlation to each other.

Investments in mid-sized companies may involve greater risks than in those of larger, better known companies, but may be less volatile than investments in smaller companies.

Investments in small-sized companies may involve greater risks than in those of larger, better known companies.

Value stocks can perform differently from the market as a whole. They can remain undervalued by the market for long periods of time.

Volatility management techniques may result in periods of loss and underperformance, may limit the ability to participate in rising markets and may increase transaction costs.

Growth stocks may underperform stocks in other broad style categories (and the stock market as a whole) over any period of time and may shift in and out of favor with investors generally, sometimes rapidly.

A momentum style of investing that emphasizes investing in securities that have had higher recent price performance compared to other securities, which is subject to the risk that these securities may be more volatile and can turn quickly and cause significant variation from other types of investments.

A "quality" style of investing emphasizes companies with high returns, stable earnings, and low financial leverage. This style of investing is subject to the risk that the past performance of these companies does not continue or that the returns on "quality" equity securities are less than returns on other styles of investing or the overall stock market.

The returns on a portfolio of securities that excludes companies that do not meet the portfolio's specified ESG criteria may trail the returns on a portfolio of securities that includes such companies. A portfolio's ESG focus may result in the portfolio investing in securities or industry sectors that underperform the market as a whole.

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2244302.1.1.GBL.RTL Exp. Date: 30/09/2019