

High Conviction: Can we all benefit?

In this Newsletter we propose a model of High Conviction Equity Management (HCEM) to better understand its performance characteristics. A critical result is the sensitivity of HCEM to size of assets under management. There is some return advantage in being more aggressive. However implicit restrictions on the minimum weighting and maximum number of stock holdings in portfolios impose a cost, because these restrictions cause portfolios not to hold attractive stocks with inadequate liquidity. This cost is small at low Funds Under Management (FUM), but, as FUM expands, this cost largely offsets the initial performance advantage. Ultimately, even at moderate FUM, the incremental performance uncertainty of HCEM may come with little or no return compensation.

A model of HCEM

In order to simulate the behaviour of HCEM and contrast with Diversified Equity Management (DEM) we need to put forward illustrative models of these alternative approaches for Australian equities.

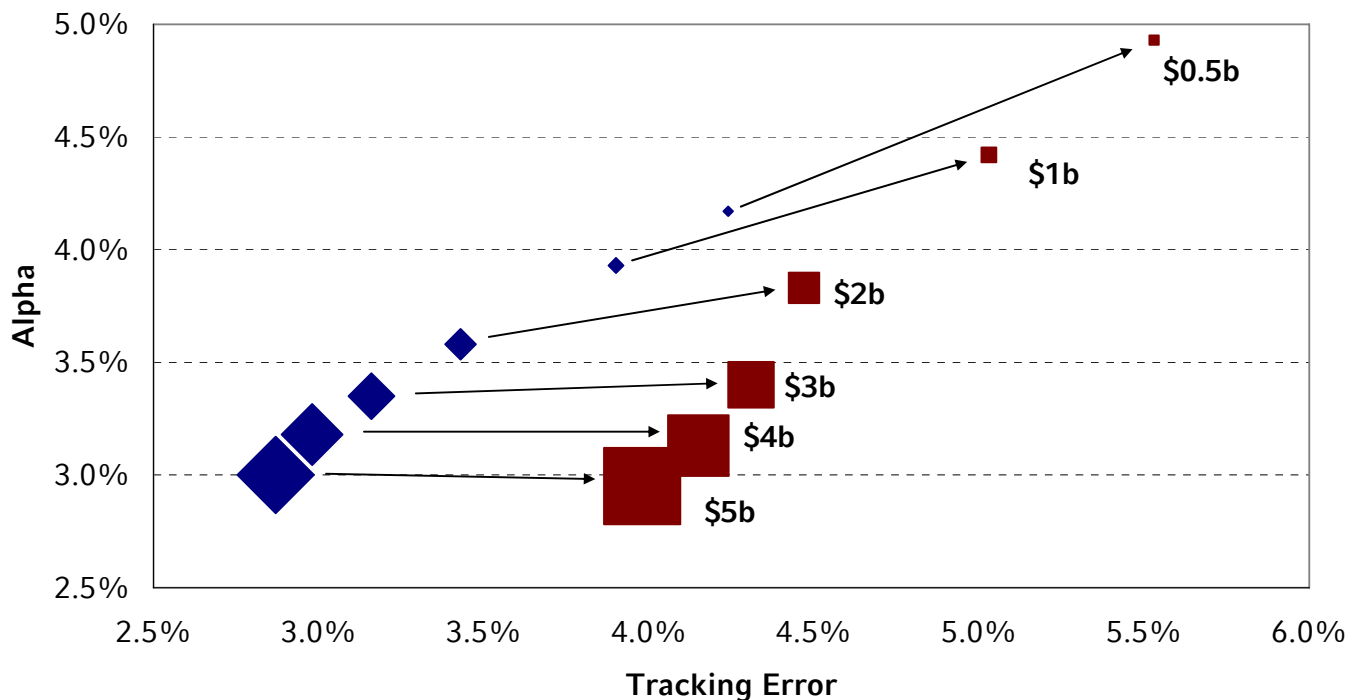
Below we specify these two alternative modes of equity management in terms of a number of simple constraints:

	Diversified	High Conviction
Minimum stock weight	0%	2%
Maximum active stock position	3%	5%
Maximum active sector position	4%	10%
Maximum days to liquidate an active stock position, impact free	30 days	30 days
Maximum company ownership	10%	10%

By active position we refer to the absolute difference to index weighting. So a 10% maximum active sector position for example would constrain a high conviction manager to hold at least some banks and some mining companies, but otherwise be free to completely ignore other sectors. The simple portfolio construction approach used here is to rank stocks by forecast alpha, then invest as much as possible, subject to constraints, in the top ranked stock, then as much as possible in the second ranked stock and so on until the portfolio is fully invested. The investable universe includes constituents of the S&P/ASX 200. Depending on the assumed manager FUM and the specific liquidity of the stock, the maximum 30 days active position may conflict with the minimum desirable portfolio weight for HCEM. The HC manager may not be able to invest enough in the stock to satisfy the cosmetic demands of High Conviction. So as FUM grows the list of investable stocks for HCEM will shorten. In the case of DEM the impact of growth in FUM is to restrict the size of position, but not to eliminate access altogether. These two alternative definitions generate typical portfolios of around 25 stocks for HCEM and up to 65 stocks for DEM depending on FUM.

The distribution of expected alpha opportunities by stock liquidity will vary over time. It is possible for perceived high alpha opportunities to be concentrated in liquid stocks so that the impact of FUM on HCEM is minimal. Alternatively high alpha opportunities might concentrate in less liquid stocks, so that the impact of FUM is accentuated. A reasonable way to neutralize this potential distortion is to simulate the distribution of possible alpha opportunities many times over, build the two portfolios, record results and focus on mid-ranking outcomes for the purpose of comparison. The following chart is based on typical, or mid-ranked, results for various assumed levels of FUM.

Shift from Diversified to High Conviction



This analysis demonstrates that the comparative advantage of HCEM is confined to relatively small FUM. Also as FUM increases, the performance potential of HCEM is severely affected, much more so than for DEM. The alpha for HCEM declines by around 2%, with expansion of FUM from \$0.5b to \$5b, compared to a corresponding decline of 1.2% for DEM. Beyond \$1b the shift to HCEM substantially increases performance uncertainty, with little commensurate improvement in expected alpha.

Not everyone can benefit

The relevance of the High Conviction phenomenon to the Australian superannuation industry arguably depends on how many competent, capacity disciplined managers with adequate track records can be identified. The latest APRA statistics count around \$650b of assets excluding self-managed funds and life offices. If around \$200b is invested in Australian equities, even a 10% share of local equity allocation would require around 20 High Conviction managers at \$1b each. So building manager configuration around high conviction is what an economist might call a 'fallacy of composition'. It may work for some funds but it cannot work for all.

High Conviction is naturally suited to investment styles that develop insights across a narrow range of opportunities. These approaches are often heavily intuition based. Alternative investment approaches that comprehensively rank a large investment universe, including illiquid stocks, are better deployed via diversified long only portfolios, or diversified long/short portfolios. Effective style diversification may require diversification across a range of portfolio construction approaches including high conviction, diversified long only, and diversified long/short. High conviction will source some alpha but by definition it cannot source all. Of the alternatives, diversified long only portfolio construction is more robust to increases in FUM and individual manager performance is typically more stable. It is likely then that diversified long only managers will continue to play a key role in delivering alpha for most Australian superannuation funds.

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