

A Blueprint for Improving Institutional Equity Portfolios

The world has changed. The period of what is now being called “the Great Moderation” is over and a return to these favorable conditions is unlikely in the foreseeable future. Thus, the sort of approaches that have worked well in equity investment in most of the last 20 years may not be well-placed to be as effective in the next 10 or 20 years.

The most obvious feature of the difference between the current decade and the Great Moderation is the seeming inevitability that developed economies will experience slower economic growth. The massive fiscal stimuli injected in 2008 and 2009 to avoid an economic and systemic meltdown have been withdrawn and the focus has turned to managing and reducing the mountain of debt left in the wake of the downturn.

Developing economies such as China and India, however, are under no such constraints. The world has, in our view, become a two-speed world.

Where are we now?

Investors invest in equities to create wealth. Therefore, the goal of an equity investor is to capture the broad market returns available from the asset class in an effective way.

Most investors aim to do this by using a market capitalization-based index – most commonly, the MSCI World Index. This approach, however, is likely to be flawed in terms of accessing the full equity market opportunity. The MSCI World Index excludes emerging markets altogether and captures only the top 85% of developed market companies, leaving out smaller, growing companies in the process. But these two parts of the whole equity market that are underweighted in these conventional approaches are perhaps the most interesting parts, in terms of both return expectation and the opportunities they present to active managers.

In addition, and more fundamentally, we believe that market capitalization indices are by their very nature flawed. In particular:

- They are prone to asset price bubbles.
- They are biased to past success.
- They risk excessive concentration.

These flaws are all well-known, but the point about past success is the most eye-catching because most investors have more than 90% of their global equity assets invested in companies/countries that collectively are expected to grow relatively slowly in the longer term.

Capturing broad market exposure

The first step in improving a global equity portfolio is to help ensure that the broad equity market return is, in fact, being accessed. In practice, this means ensuring that the portfolio is not strategically underweighted by excluding emerging markets and smaller companies.

The second step is to address the flaws of the market capitalization benchmark itself. To avoid concentration risk and help mitigate the consequences of future asset price bubbles, a fixed-weights approach has merit, especially when combined with periodic rebalancing back to the agreed fixed weights.

The forward-looking approach

So far, we have set out the principles of building an equity portfolio that we believe should capture the full equity market return opportunity effectively and offset some of the known disadvantages of the simple market-cap index approach. But savvy investors should do more than this – they should want to build a global equity portfolio that is expected to have superior characteristics in return and risk terms in the longer term.

The sources of additional return are well-known. Both emerging markets and smaller companies are expected to generate, in the long term, higher returns than developed large-cap markets. But these returns will also come with higher volatility.

In addition, investors should expect greater returns from managers who are skilled in following these principles while managing risk. Simply making strategic over-allocations to emerging markets and small cap will not improve the risk/return characteristics of the global equity portfolio on its own; it will just increase both expected return and expected risk. To counterbalance this, the forward-looking global equity portfolio structure needs to include a component that will have naturally lower risk characteristics, but without material compromise on the return expectation.

The combination of high-growth components (emerging markets, small cap) and a defensive, low volatility component should deliver an equity portfolio that, in total, has a higher return expectation but not materially higher risk – exactly what investors seek.

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Conclusion

The current approach to global equity portfolio construction has some significant flaws in the new environment we are facing. We believe that these flaws can be addressed to produce a superior equity portfolio construction.

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