CONCENTRATING ON WHAT MATTERS

How can an investment strategy deliver the returns clients require? By focusing on the important elements that drive performance, says ***Harry Bazzaz****, investment manager at Rocq Capital.*

We were interested to read a recent study by global advisory firm Willis Towers Watson ('Better Equities: Redefining Active', 2017) which found three key factors that improve expected investment performance. These are:

- Concentrated holdings to maximise long-term returns
- Low turnover and suitable fund choices to limit the drag of costs
- Appropriate diversification to reduce risk

Concentration refers to the number of holdings a fund has and the weight given to the largest positions. A highly concentrated fund is likely to have relatively few holdings, each given a significant allocation. If done skilfully, a manager's best ideas are emphasised rather than being diluted by other holdings.

Our average holding period, for example, is approximately four years. Using tax efficient vehicles and appropriate situs of assets is also a consideration so that there is no unnecessary tax leakage for investors.

As an example, one of our emerging market equity funds holds 39 stocks from a potential universe of 837, selecting companies that are well-positioned to benefit from consumer trends in developing economies. Similarly, a US fund in our portfolios has only 22 positions compared to its benchmark's 500.

This philosophy can be extended into the way portfolios are put together. Once an attractive investment opportunity is identified, it can be given enough allocation to enable it to make a meaningful impact on the returns of a portfolio as a whole. A relatively small number of high quality holdings can be held, each with a significant allocation.

Remaining invested for a number of years can allow themes to play out but also avoid the transaction costs associated with frequent trading. Our average holding period, for example, is approximately four years. Using tax efficient vehicles and appropriate situs of assets is also a consideration so that there is no unnecessary tax leakage for investors.

Nobody can know how financial markets will behave in the future, but clients' portfolios can be prepared to withstand different scenarios. Diversification is the concept of not putting all one's eggs in one basket – making a range of investments that will behave and perform differently depending on what is going on in the world.

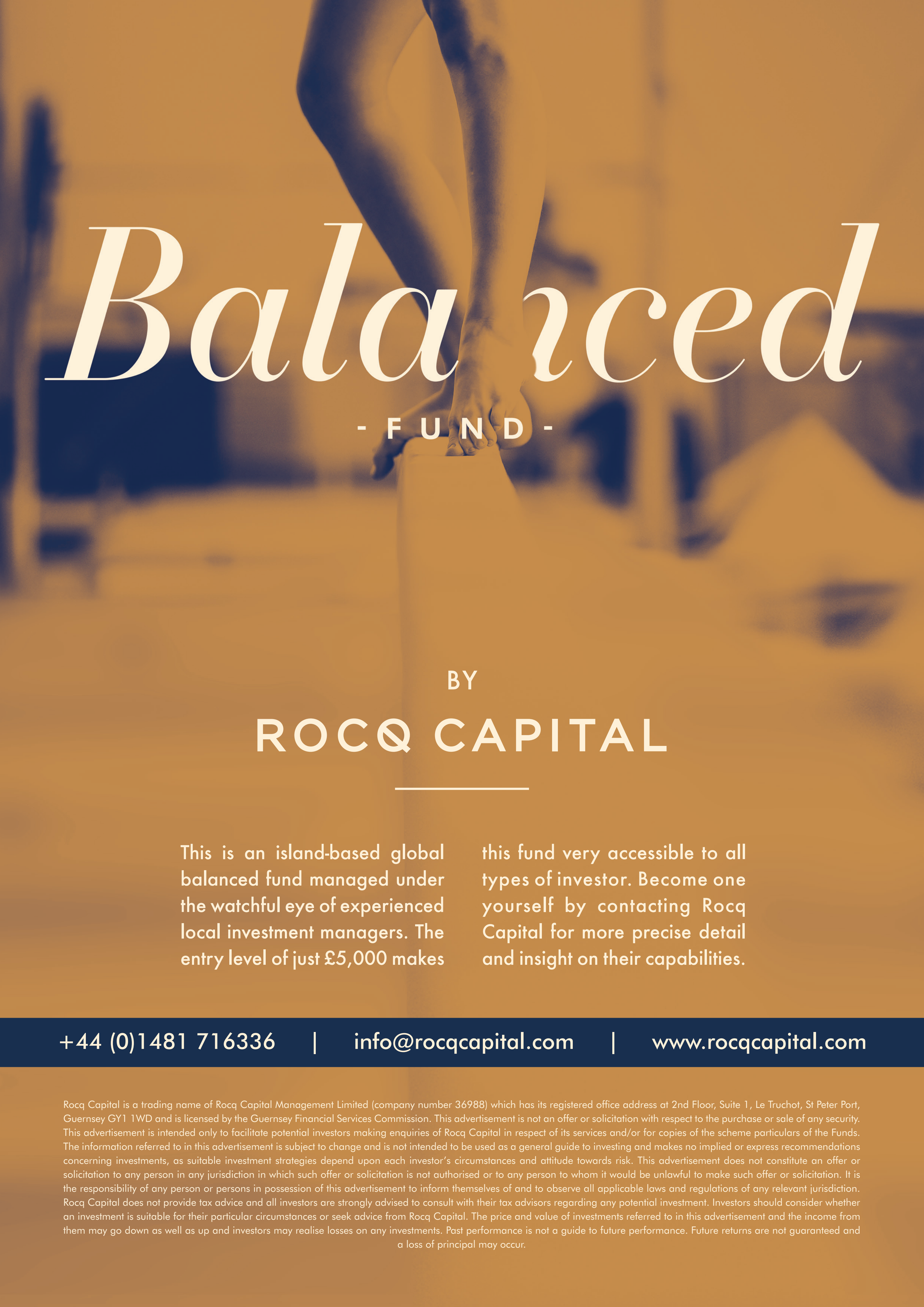
This means understanding, under a range of circumstances, the interaction between the performance of various fund choices and the effect that a new holding will have on an existing portfolio. Different levers work at different times, with the goal being to reduce the risk of a portfolio dropping significantly in value, even under challenging market conditions.

An important element of diversification can be gaining access to 'alternative' strategies. This can be seen as an all-encompassing definition of any asset class or strategy other than traditional holdings in bonds and equities.

If utilised effectively, such an allocation can reduce risk while still delivering attractive returns within a portfolio as a whole. As an example, two of our key holdings have correlations with the rest of our funds of -0.13 and +0.20 respectively, indicating they have moved in quite an unrelated way to our other investments. With both equity and bond markets at elevated levels, and the first quarter of 2018 notable for a return of volatility in financial markets, a focus on this type of investment seems particularly pertinent now.

While concentration and diversification may seem opposing ideas – a concentrated portfolio is not usually as well-diversified as one that holds hundreds of positions – an approach that combines the two forces can form an effective partnership: each fund may be concentrated in isolation, giving it the potential to perform strongly, but in combination with others risk is reduced for a portfolio as a whole.

Adherence to this approach can result in a consistent, repeatable investment process that delivers steady positive returns – and provides the building blocks for clients' portfolios today and in the future. ■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