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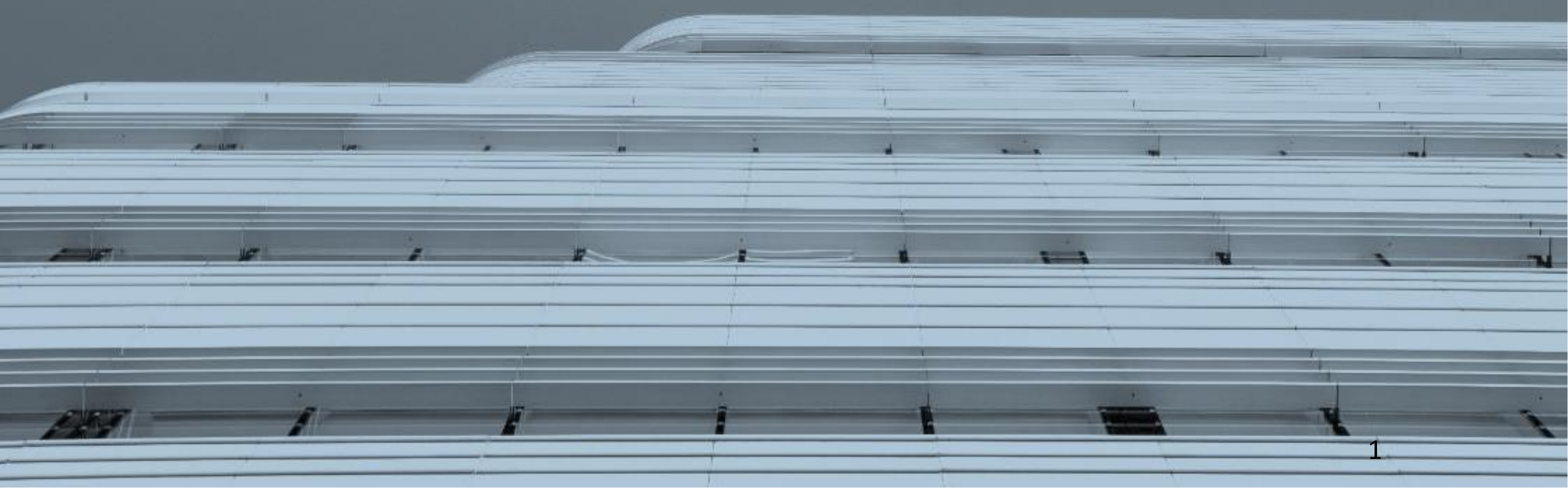
Hosking Post

The Only Free Lunch in Finance?

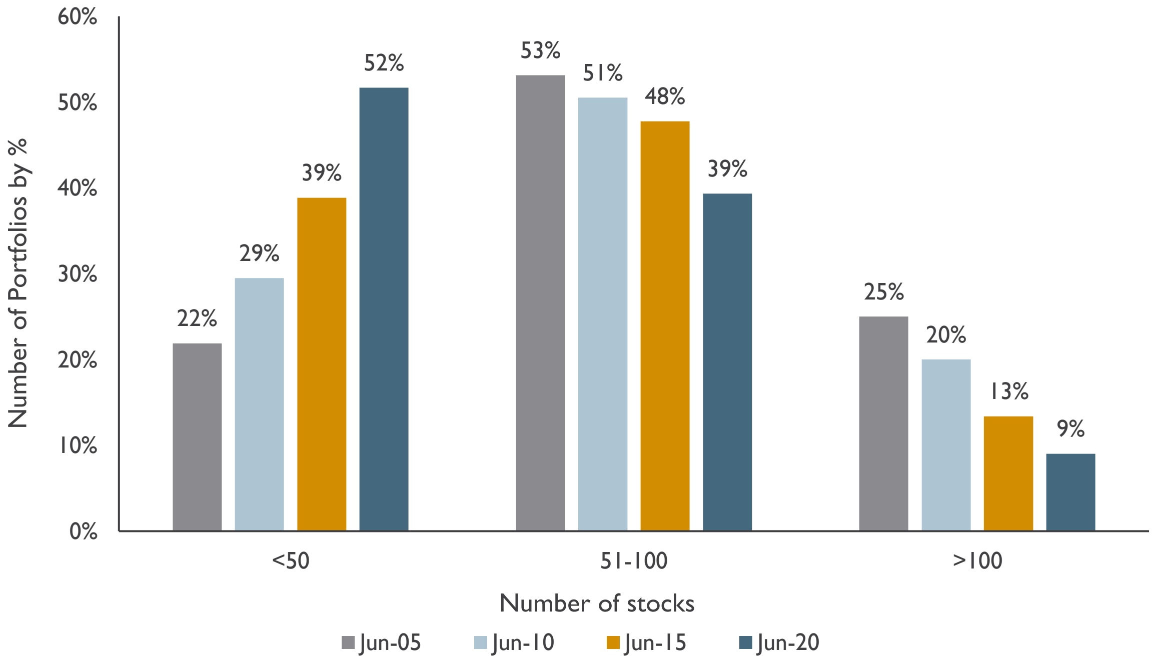


It would appear that Harry Markowitz's observation that diversification is the only free lunch in finance[1] enjoys little support in today's investment landscape. In this Hosking Post, we try to understand why concentrated portfolios have become so fashionable, and why a diversified portfolio still has a role to play in the asset manager line-up of large institutional investors.

The age of the concentrated portfolio

According to data provided by InterSec, over 90% of active global equity managers have portfolios of less than 100 shares and over 50% of those managers have portfolios of less than 50 stocks. Conversely, the number of portfolios with more than 100 stocks has fallen from 25% of the total 15 years ago to just 9% today. Chart 1 illustrates this trend towards more concentrated portfolios over the past few years.

Chart 1: Number of holdings of fundamental equity products



Source: InterSec Research. Based on number of holdings of fundamental global equity products. 30 Jun 2020.

Several factors have driven active managers in the direction of more concentrated portfolios.

[1] *Against the Gods: The Remarkable Story of Risk. Peter Bernstein. 1996.*

1. **Passive investing:** the rise of passive investing provided a low-cost alternative to active management and focused attention on the fact that most active managers fail to beat their benchmarks after fees. Active managers have realised that they need portfolios significantly different from the market (measured in terms of active share) to have any hope of beating the market and therefore attracting business. The quest for high active share is expressed, very largely, via concentrated portfolios, even though high active share can also be found in more diversified portfolios.

2. **Asset Class Proliferation:** the adoption by institutional investors of a wide array of new asset classes, such as emerging markets, private equity, property and hedge funds in the early 2000s resulted in diversification between asset classes and reduced the imperative for fund managers to diversify within the asset classes. It gave fund managers a narrower opportunity set over which to demonstrate domain expertise. It helped that the promise of such expertise (albeit over a smaller field), coupled with the resulting capacity constraints, was perceived to justify charging higher fees. Half the job for twice the price!

3. **The age of analytical certainty:** accompanying this trend to specialisation were Ivan Boesky-inspired legal and regulatory changes which outlawed an information edge as a way of achieving a competitive advantage in stock selection. Asset managers were forced to swap an informational edge for an analytical advantage to get ahead – an entirely different and more labour-intensive occupation, but one which endowed the managers with greater confidence in their stock-picking abilities! This gave birth to the age of analytical certainty as expressed in the concentrated portfolio.

Analytical certainty

At Hosking Partners, we regard the concept of analytical certainty as elusive. Research shows that when measured over the long period since 1926, just 4% of listed stocks produce 100% of the value created by the market, and over the period since 1990 the figure is even smaller at just 1.3%.[2] Conversely, 54% of stocks under-perform the market over the long term and 40% of stocks have negative returns in absolute terms.[3] The job of the asset manager is to sniff out the handful of winners whilst managing to avoid the losers! A tough task which, if possible, seems to suggest that managers should pick the winners and hold

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[2] *Do Stocks Outperform Treasury Bills? Journal of Financial Economics, Vol. 129, No. 3. Hendrik Bessembinder. September 2018, 440-457.*

[3] *The Agony and the Ecstasy: The Risks and Rewards of a Concentrated Stock Position. Eye on the Market: Special Edition. JP Morgan Asset Management. September 2014.*

onto them. Turnover data tell a very different story. A sample of 95 active global equity managers (dominated by portfolios of less than 50 shares) shows that managers are, on average holding shares for no longer than 2.5 years.[4] The suggestion is that they are looking for shorter-term payoffs, in line with the time horizon of their remuneration arrangements or career appraisal metrics, rather than the longer time horizons over which their clients would prefer high returns to be sustained.

A different kind of active share

We agree that high active share is necessary if one is to have any chance of performing differently from the index. But as opposed to the orthodoxy of holding a small collection of large-cap stocks in high concentration, the Hosking Partners portfolio achieves high active share by holding a large number of holdings across the cap spectrum with close to a third of holdings in off-benchmark securities.

As a brief aside, despite the fact that we are natural contrarians, the number of stocks in our portfolio is not based on a decision to do things differently from the herd – although we believe that is generally a very sound practice. Our 450+ stock portfolio is a consequence of our global generalist multi-counsellor investment process. Five independent portfolio managers, each with a global remit and the broadest possible opportunity set, autonomously manage portfolios averaging about 100 shares. When the five portfolios are combined, the result is a 450+ portfolio of names as certain shares are owned by two or more of the underlying five portfolios.

A portfolio with a long tail

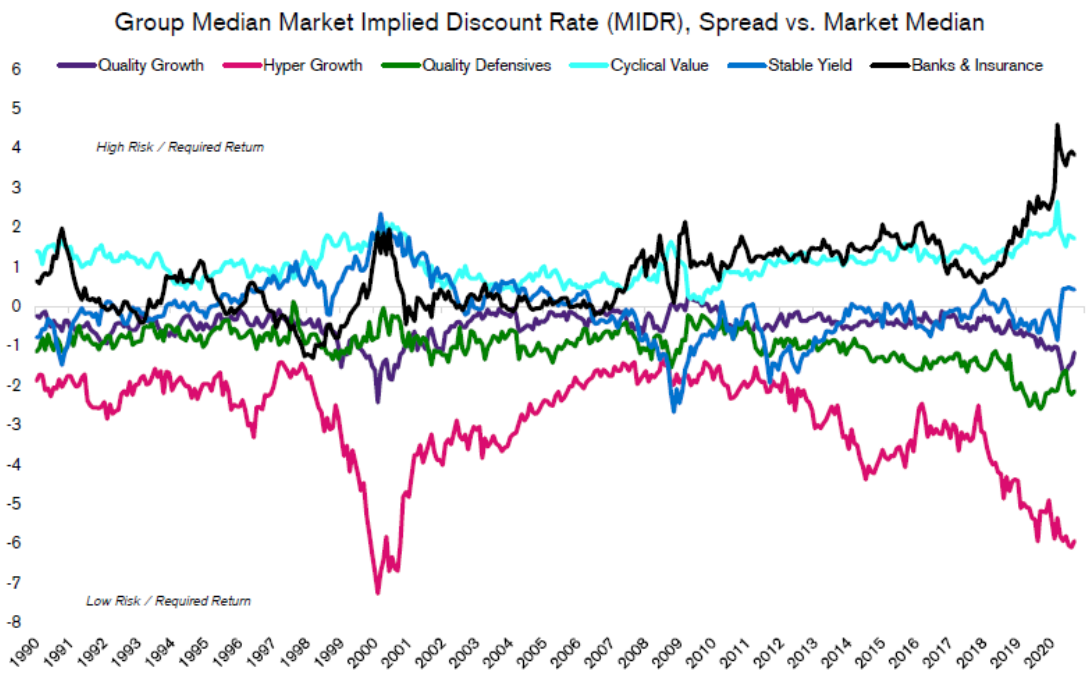
Discussions on the number of stocks in our portfolio and the long tail of small holdings frequently come up in our meetings with clients, consultants and prospects, so we have spent a lot of time thinking about the subject. Periodically, the portfolio managers undertake a review of their smaller holdings, though this often results in limited action! We believe that the fact that we find it so difficult to do tells us a lot about the stocks in the tail of the portfolio and this feeling is supported by some analysis we have commissioned.

We defined tail stocks as the stocks that make up the bottom 10% of the value of the overall

[4] *eVestment Global Core Equity Universe with active, fundamental. All Cap, ACWI approach. As at 30 Sep 2020, the universe consisted of 95 firms , 162 products.*

portfolio when ranked by position size. We used Credit Suisse's HOLT return on capital valuation framework to understand the tail stocks as a group. The HOLT Market Implied Discount Rate derives a discount rate by unpacking a company's share price and forecasts of future growth and returns (see chart 2). By way of example, Apple has a Market Implied Discount Rate of -0.6% and Wells Fargo a Market Implied Discount Rate of 8.5%, and the stark contrast between the two is a microcosm of the bifurcation in the market: growth stocks that are currently popular benefit from very low implied discount rates, while everything else is punished to varying degrees.

Chart 2: HOLT Market Implied Discount Rate



Source: Credit Suisse HOLT, Data Date: 8/31/2020. Market Implied Discount Rates for Financial firms on the HOLT CFROE model are trimmed by 150 bps throughout this analysis to preserve comparability.

HOLT allows analysts to triangulate forecasts of a company's fundamentals, discount rate and valuation to investigate market expectations, whether of future performance or intrinsic value. In order to look through the market's current sectoral preferences as expressed in the widely varying Market Implied Discount Rates, we asked HOLT to apply a standardised 5% discount rate across shares in the Hosking Partners portfolio.

The resulting HOLT analysis showed that based on the flat 5% rate, the average valuation upside in the 197 stocks that make up the tail of our portfolio is three times higher than that of the portfolio as a whole. The tail may therefore be regarded as an extremely diversified basket of higher risk and higher return stocks who precisely because of their higher risk attributes would be challenged to find their way into more concentrated portfolios.

Bear in mind that these tail stocks are not just selected on the basis of being cheap. They are bought because they satisfy one or more of our mental models – the lens through which we view the world – AND they are cheap. If any one of our mental models on their own increases the likelihood of success for a portfolio company then the presence of a combination of these filters will improve chances further. One mental model that is particularly relevant to the portfolio tail is that of “spin off” companies (we have to admit that Wall Street got to it first in terms of identifying this as a source of alpha for the patient contrarian). Over the years the spin-off mental model has proved its worth with several successful investments – Paypal, Montauk and Topbuild being a few of the more recent examples. Spin offs very often find their way into the tail of the portfolio and it would be unwise simply to sell these stocks because they are small positions. Is there reason to believe that one spin-off stock representing 20 basis points of the portfolio would be a better option than four spin-off stocks each of 5 basis points?

The two-tier market and portfolio crowding…

The two-tier market we currently find ourselves in has undoubtedly been supercharged by generous central bank liquidity, but passive investing and copycat herding into concentrated portfolios has played more than a minor role. A portfolio manager with nearly 50% of the value of his portfolio in 10 stocks is going to look for certainty in his investee companies. But his selection is also likely to be reflect the momentum factor, and the skewness of recent returns towards megacap growth stocks has resulted in an extremely lop-sided market as size begets more size, and the memory of mean reversion is temporarily suspended. This is not going to have a happy ending in the long run.

…turns the job of the allocator into a hunt for capacity

The herding into concentrated portfolios is unlikely to benefit asset owners as much as it will benefit active asset managers. Besides paying higher fees to concentrated managers to reward them for their specialist expertise, manager selection has just become more difficult. Selecting that handful of skilful managers who can out-perform the index is a difficult task. Instead of picking 20 managers holding 100 stocks an asset owner needs to now select 100 managers holding 20 stocks. Asset owners and consultants spend a lot of effort on manager selection, endeavouring to ensure that the 100 managers don't all hold the same stocks. The illusion that this is possible might be achieved by back-testing using historic data, but one thing we know for sure is that future market dislocation will not precisely follow the path of past crises, and negative correlations can quickly turn into synchronised risk. The problem is not just that assembling a stable of too many managers may not achieve the desired effect of diversifying away risk, but it will almost certainly blunt returns, with active risk reducing rapidly as more managers are added to a portfolio. This is a problem when large endowments had an average of 108 managers in 2019, up from an average of just 18 in 1994.[5]

There must be another way!

Both passive strategies and concentrated, growth-oriented equity strategies have outperformed a diversified portfolio over the past 5 years. However, now may be a good time to reconsider diversified equity portfolios. Our diversified portfolio with low stock-specific risk (and high active share) can venture into areas of the market not readily accessible to concentrated managers. In addition, our approach provides us with far fewer capacity constraints, enabling clients to grow their investment as they scale rather than devote precious time to find another manager doing a similar job.

Thanks for your time. I am off to lunch!

Luke Bridgeman & Jenny Buchanan

November 2020

Please find the link to the accompanying Hosking Podcast here.

[5] *Failure of the Standard Model of Institutional Investment. Richard M. Ennis. October 2020.*