

# IFM Active equities – Key research insights 2020

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February 2021

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2020 was a busy year, with the IFM Large Cap Active Equity Team authoring four white papers based on their proprietary empirical research. Here we provide the main insights from these papers and what we see as their implications for portfolio management and fund allocators.<sup>1</sup>

**Our first paper, *Concentrated managers – Fool’s gold or a sound multi-manager building block? Is Extended Alpha a better alternative?* (March 2020)**, draws on two decades of data to empirically test the thesis underlying the use of concentrated managers (portfolios with fewer stocks that seek higher return targets). We find Australian concentrated manager portfolios tended to add to risk but did not generate additional alpha as tracking error increased. Drawdowns by concentrated managers have been significant, with a worst drawdown of 40% and a median drawdown of 11.5%, with a 49% chance of fund closure. A viable alternative is to add shorting capability to a lower risk portfolio and we believe this is a better approach for investors seeking higher potential returns.

**Our second paper, *A better approach to consistently improve the return from Australian equities* (May 2020)** observes that after chasing lower fees in passive investments, allocators are turning their attention towards adding low fee alpha. In light of this, we provide a framework of desired attributes for Low Risk Active (LRA) funds and empirically analyse 20 years of data on existing funds to better inform allocators of where LRA funds have and have not worked. We found that

most LRA funds fail to meet their return objective and often exceed their risk limits. Our study also confirmed our belief that there is an alpha ‘sweet spot’ for LRA funds between 0.3% and 0.7% tracking error.

**Our third paper, *Tracking error got your back – don’t count on it!* (September 2020)** outlines the pit-falls of relying too heavily on tracking error as a key measure of portfolio risk as it is a narrow measure of risk that ignores the ‘tails’ associated with any distribution of potential returns. We also suggest alternative risk measures like skewness, alpha consistency, drawdowns risk and deviation, and empirically test their efficacy using the last 20 years of Australian fund manager returns..

**Our fourth paper, *Expectations @ risk – new developments and value added* (December 2020)**, provides a recap of our Expectations at Risk (E@R) technique (a forward looking alpha and risk mitigation signal) that the team developed in 2006 to address an observable weakness amongst systematic managers – the potential to suffer large drawdowns, or negative skewness, in their returns. It also details some recent new developments and demonstrates how E@R has added value to our large cap active equity portfolios since it was implemented in 2006.

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<sup>1</sup> These summaries focus on the key insights and portfolio implications of each white paper. Full versions of these white papers, which include details of the methodology used in each empirical study, may be available on request.

## Background to our research

### IFM's approach to large cap active equities

Within our large cap equity portfolios, our philosophy centres on the belief that listed equity markets are relatively efficient and that the best way to generate consistent value is to use a systematic (or quantitative) approach combined with the judgment and skills of a fundamental overlay.

The systematic foundation of our investment process seeks to exploit market mispricing

opportunities in stocks using well-known and IFM developed systematic signals. These anomalies include the mean reversion trading behaviour seen in value investing, operational improvement at the company level and the shorter-term trending behaviour seen in sentiment and momentum investing. We also use market intelligence indicators to strengthen our signals and to trade out of positions that are not adding value. We believe that integrating ESG, at both the stock and portfolio levels, also has the potential to deliver stronger risk adjusted returns.

### The role of proprietary empirical research and testing

Proprietary empirical research and testing are key components of our approach to large cap active equities. Through our own research, we seek to continuously evolve our investment process

as markets change and existing anomalies are arbitrated away.

We believe this continual evolution of our investment approach through in-depth research has been critical to the team's track record over the past 20 years.

## Key research insights of 2020

The main insights from our 2020 research are detailed in the summaries below.

### **Concentrated managers – Fool's gold or a sound multi-manager building block? Is Extended Alpha a better alternative?, March 2020**

Concentrated managers have become popular due to investors seeking higher returns and additional benefits, such as lower redundancy. The thesis that higher returns (alpha) can be generated by shrinking the portfolio to only hold a manager's "best" ideas appears sound in theory. In this paper, we empirically test this hypothesis using 20 years

of Australian data from January 2001 to December 2019.

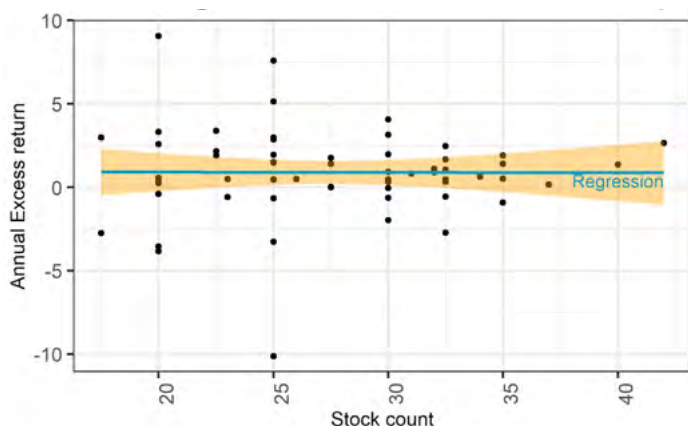
Our analysis suggests that Australian concentrated managers only deliver around 30-40% of their asserted return targets and generally fail to achieve their risk targets. Alpha consistency amongst concentrated managers was also historically volatile, with only 12% of managers outperforming in at least 60% of months, while 30% of managers underperformed in more months than they outperform.

More worryingly, periods of negative performance (drawdowns) have been extreme amongst concentrated funds. The worst drawdown in our study was 40% and the median drawdown was 11.5%. There was also a 49% chance of fund closure during the 20 year period. So our analysis showed that the theory underlying concentrated portfolio's generating higher returns is not supported in practice. Equity allocators have historically had a 15% probability of picking a manager with an Information ratio (IR) above 0.75.

We believe that adding shorting capability to a lower risk portfolio is a better approach for



**Our analysis suggests that Australian concentrated managers only deliver around 30-40% of their asserted return targets and generally fail to achieve their risk targets**

**FIGURE 01 INCREASING CONCENTRATION DOESN'T NECESSARILY ADD EXTRA ALPHA**


Source: Mercer, IFM Investors

investors seeking potentially higher returns. Risk controlled shorting addresses the skewed Australian market (a small number of large cap stocks dominate the index) by allowing negative views to be expressed. Shorting can fund larger positions in favoured stocks without the negative side effect of less diversification. It can also increase thematic exposures and provide better stock specific risk control.

#### **A better approach to consistently improve the return from Australian equities, May 2020**

Fee compression and recent poor performance by active managers have caused passive ownership to grow to ~15% in Australia. With fees now reduced, we observed that allocators are keen to add low fee alpha back into their portfolios with the added benefit of adjusting risk outcomes. The 'Your Super, Your Future' reforms will also likely make lower risk, consistent alpha products even more appealing. However, selecting a successful Low Risk Active (LRA) fund has historically been challenging for allocators.

This paper suggests a framework of desired attributes for Low Risk Active (LRA) funds and empirically analyses 20 years of data (January 2001 to December 2019) on existing funds to better inform allocators of where LRA funds have and have not worked and how they match up to the list of desired attributes.

We believe the attributes investors should look for when considering LRA portfolios include risk control, consistent performance, low drawdowns, a long term track record, low fees and a favourable alpha to fee ratio that incentivises them to switch to LRA which typically has higher risk than their current indexed fund.

Our study analysed existing LRA funds across the following metrics - realised historical returns compared to advertised

targets, whether investors are compensated for higher risk with higher returns, consistency of performance and the severity of drawdowns.

Our comparison of return targets with realised alpha shows that only IFM and one other LRA fund met their stated return objective. With the exception of IFM, no fund achieved an information ratio above 1 and most funds in the study did not add consistent value through time.

Many LRA funds have regularly exceeded their stated risk limits and experienced material drawdowns. We believe this suggests a deficiency in portfolio construction techniques and an over-reliance on backwards looking risk models. Approximately 40% of LRA funds closed during the 20 year period, leaving investors with additional switching risk and adverse sequencing costs. Our study also confirmed our belief that there is an alpha 'sweet spot' for LRA funds between 0.3% and 0.7% tracking error.

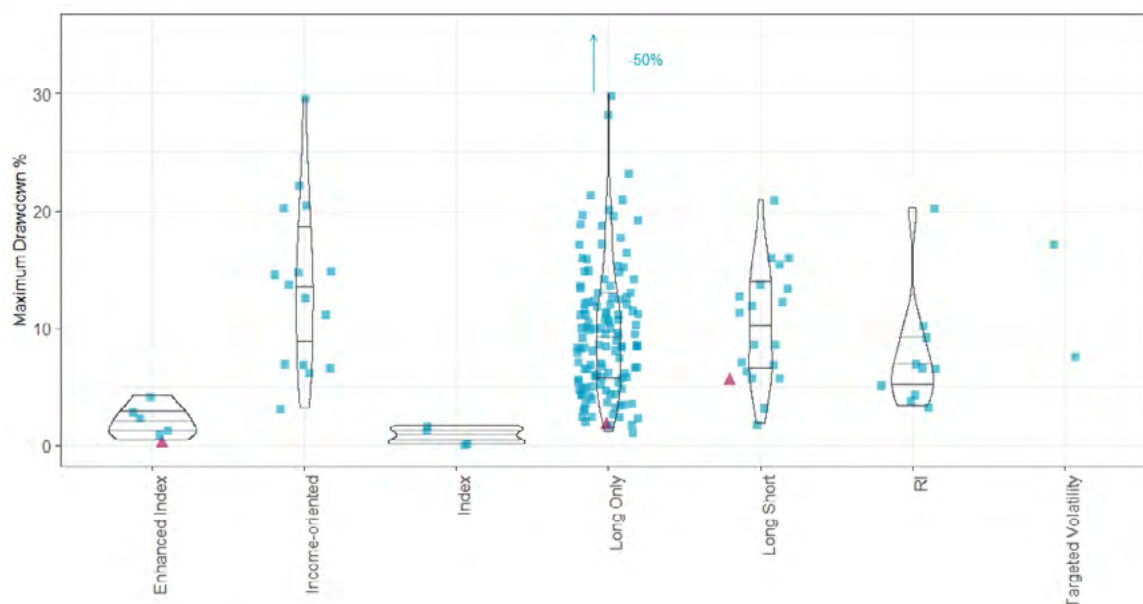
#### **Tracking error got your back – don't count on it! , September 2020**

Within the institutional market, there tends to be an over-reliance on tracking error (TE) as a key risk metric for categorising and selecting managers. This paper outlines the pit-falls of relying heavily on TE as a key measure of portfolio risk. TE is a narrow measure of risk that ignores the 'tails' associated with any distribution of potential returns.

Tracking error needs to be estimated using historical data which could be subject to biases and non-stationary parameters. For example, during times of crises, volatility tends to increase and correlations move towards one. So models often underestimate TE going into a crisis (when they are needed most!) and overestimate it as the crisis subsides.

TE is used to measure the risk of a fund underperforming its benchmark – it is calculated as the standard deviation of excess returns. So two-thirds of a portfolio's returns are expected to fall within the tracking error band. But our empirical data shows that greater portfolio risk lies in the tails of the return distribution and these risks are asymmetric. The upper tail – abnormally large returns – tends not to be of concern to investors, but the lower tail – abnormally weak returns – can result in significant drawdowns and wealth destruction.

This can be illustrated by data from our empirical study which shows that the worst drawdown for a long only manager was 50%, while the median long and long/short manager had a drawdown of around 10%. Drawdowns were also a multiple of 2.5 to 8.5 times target TE across the median to worst drawdown manager.

**FIGURE 02** MAXIMUM DRAWDOWN BY SUB-UNIVERSE (IFM = RED TRIANGLE)


Source: IFM Investors, Mercer

To better understand portfolio risk, we believe TE should be combined with other alternative and complementary risk assessment measures such as:

- Downside risk measures like the Burke, Calmar, Martin and Pain ratios and the Ulcer index;
- Downside deviation (semi deviation and loss deviation) which measures the variability of underperformance;
- Return distribution and alpha consistency that provide insights into the probability of luck and the use of risk budgets.

#### Expectations @ risk – new developments and value added, December 2020

The E@R technique is a forward looking alpha and risk mitigation technique that the team developed in 2006 to address an observable weakness amongst systematic managers – the potential to suffer large drawdowns, or negative skewness, in their returns. This paper provides a recap of our E@R approach, outlines recent new developments and details the extent of the value it has added to our large cap active equity portfolios since it was implemented in 2006.

E@R uses statistical techniques to help us to identify inflection points in future earnings, crowded trades and potential value traps. E@R's ability to identify stocks with inflection point potential amongst the systematically least preferred stocks also carries across to our systematically preferred positive alpha model names. In 2015, using a decade worth of empirical data, the team verified that E@R

had merit as an alpha signal in addition to a portfolio risk mitigation technique. This analysis calculated the long short returns to be 8% and 11% over a six and twelve month period for stocks with a significant E@R reading.

The relative contributions from our underlying alpha model and E@R are impacted significantly by the market environment. Typically, a more steady state, trending market will result in the vast majority of the return coming from the alpha model as there are few or no major turning points. This was observed in calendar years 2007, 2009, 2013 and 2015, where the majority of alpha was generated by our underlying investment model, with some small additional alpha contributed by E@R.

In 2020, returns from our systematic signals were mixed, given the impact of COVID-19 on economies and the accompanying sell-off and sudden rebound in equity markets. Instead, the excess returns to Core and Extended Alpha were largely driven by the fundamental inputs of E@R, special situations (e.g. placements), transient risk management and implementation (profiting from shorter term opportunities due to significant market volatility).

Sole attribution of E@R is not straightforward as there are often overlapping reasons for holding a position during the life cycle of the investment. Drawing on around 14 years of application, we typically expect E@R to contribute 15%-25% of our expected return over the long term.

## MORE INFORMATION

For more information on the IFM Active Large Cap Equity Team and their research, or to request a copy of the white papers mentioned in this article, please contact your IFM Investor Relations representative at [investorservices@ifminvestors.com](mailto:investorservices@ifminvestors.com)

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IFM-18FEBRUARY2021-1506499



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