

Portfolio Breadth: The forgotten success factor in active management

One of the less well known, but no less important, works of literature on investing is “*Active Portfolio Management*” by Richard Grinold and Ronald Kahn, two of the early leaders of Barra, a pioneering risk management firm. The core concept of the book is the Fundamental Law of Active Management, which measures an active manager’s ability to deliver alpha versus a passive benchmark (adjusted for risk) as a function of two elements:

1. How good the manager is at selecting securities (skill); and
2. How broadly he or she can apply that ability (breadth).

While many practitioners spend a majority of their time focused on evaluating a manager’s skill, in this paper, we highlight the importance of breadth within the investment process. In particular, the need for independent sources of information to ensure that breadth is achieved. We also discuss several potential sources of information that may add breadth, including company management, analysts and informed investors.

Breadth measures the number of independent active ‘bets’ a manager makes relative to the benchmark. In this regard, we will dive into the role breadth plays in the investment process. Without dismissing the importance of manager skill, according to Grinold and Kahn’s law, there is, unfortunately, no universally agreed-upon approach to measuring manager skill (or lack-thereof!).

In the case of breadth, the situation is clearer. A manager who only invests in technology sector stocks, for example, has less potential breadth than a manager who can invest in the entire market. Similarly, a manager who uses a single metric to select stocks, for example a stock’s price-to-earnings ratio, has less breadth than one who uses multiple metrics to narrow the universe of names to a sensible number of candidates to hold in a client’s portfolio.

For breadth to be achieved, it is essential that the bets or opportunities be independent of each other. If a manager buys 50 stocks for 50 unique reasons, he or she is making 50 independent bets. However, a manager who buys 50 stocks because they all have a low price-to-earnings ratios is actually making only one bet: cheap stocks will outperform the index.

Independence between bets is key to providing breadth. Many managers who adhere to a single style or factor of investing lack breadth in their portfolio and thereby limit their ability to add value over time. Economic cycles, investor preferences and other market trends determine the majority of their portfolio’s active returns and, without specific analysis into different companies or segments of their portfolio, their relative performance will lack consistency.

It’s Called Smart Beta Because You Betta’ be Smart

In reaction to the limited success of active managers as a whole to add value relative to passive benchmarks, a new investment concept has emerged that provides relatively low-cost access to a variety of pseudo-passive portfolio construction strategies: so-called “smart beta” indexes. Smart beta indexes are built around market exposures to basic characteristics or factors that historically have performed better than the standard market-capitalization approach used in traditional (or dumb?) indexing methodologies.

Instead of the β^2 of your portfolio being relative to the traditional capitalization-weighted defined market, the ‘smart’ beta is defined by an alternative weighting scheme with factors that include income, volatility, momentum or others. Firms that offer smart beta products tout exhaustive, often back-tested, evidence of how their redefined beta has delivered superior returns compared to traditional market cap weighted beta. While the investment merit of these strategies may be debatable, they have gained significant traction in the marketplace with over \$400 billion invested in smart beta-based exchange traded funds.

In our opinion, the obvious shortcoming of smart beta products is their lack of breadth. In other words, the prospect for future outperformance is essentially one bet. In addition to narrow breadth, investors are counting on a persistence of the same historical performance patterns going forward. The lack of breadth in smart beta products may mean that their performance, while potentially positive in some periods, will encounter significant inconsistency.

Ultimately, smart beta strategies can become victims of their own success, as they have only limited capacity to create market-beating returns. They may outperform for

a while, but lacking breadth, the more assets they gather, any potential future alpha will be diluted away. The ultimate irony is that by providing an easily accessible method to access these strategies, they provide the means for the market to eliminate any benefit that style of investing affords.

Knowledge Shall Set Your Manager Free

At HighMark, one of the core principles of our investment philosophy is developing strategies that rely on diverse sources of independent information or wide breadth. In our core U.S. equity strategies, we have designed an investment process around what we call ‘information-based investing’ to draw from a broad and diverse range of investment sources and data.

Information-based investing is grounded in the belief that there are two ways an active manager can establish an edge and deliver alpha. He or she can have **better sources** of information than the competition or can be **better at analyzing** the information that is gathered.

HighMark’s approach to information-based investing seeks to benefit from both approaches by using our analytical capabilities to identify market participants who have superior information. By analyzing the activity of these participants, we aim to harness a broad set of independent criteria for selecting stocks and thereby achieve portfolio breadth. There are three primary groups from which we gather information.

Company Management: Company managers often have special insight into what is in store for their firms, and although they may not communicate this information directly to the public, monitoring how they manage capital can provide insight as to what lies ahead.

Equity Analysts: Buy and sell ratings from industry analysts are often fairly worthless, but the information they produce supporting the recommendation can be insightful.

Informed Investors: There are many non-informed reasons why stocks are bought: portfolio rebalancing, corporate actions, investment programs, etc. On the short side, however, trading is primarily driven by informed active investors, such as hedge funds.

A Veritable Cornucopia of News

Information-based investing is like a theatrical production with an ensemble cast where there are no true leads. Success or failure is not entirely dependent on one actor’s performance, or in the case of investing, one factor.

Company managers have a truly unfiltered view of the firm, and despite what may be externally communicated, act in a manner that may signal future performance.

Analysts use methods specific to their industry to generate data and analytics that lead to their recommendations. An energy analyst, for example, will use a different set of data points to value and forecast earnings for an oil drilling firm than a consumer analyst would use for a big-box retailer. Knowing how these frames of reference vary across different types of analysts is key to making investment decisions based, in part, on the wealth of information analysts produce.

Investors behave the same way as management: while there are discernible patterns among the ‘smart money’ investors, ultimately all well informed investors are continually striving to innovate to outperform and differentiate themselves from their competition. As a result, the patterns, while discernible, are always shifting in their focus.

Conclusion

Nearly three decades after the Fundamental Law of Active Management was formulated³, it remains a foundational concept that reminds us that skill is only half the equation for risk-adjusted-alpha.

Strategies with large breadth require multiple sources of independent, insightful information and an investment process that effectively analyzes a blizzard of data. In HighMark’s case, sources include company management, stock analysts, and the activities of informed investors. If the information sources for these strategies are truly numerous and independent, and the investor is skillful, then at any given time many of his or her bets will succeed while some will fail. The net effect, over time, should be positive and lead to consistent and steady performance relative to benchmarks and peers.

To cite an age-old, and probably overused, baseball metaphor, a successful investor will be comfortable hitting many singles and doubles instead of swinging for the fences in hopes of an occasional home run while increasing the risk of strike outs. In baseball, however, teams have 27 outs over nine innings and there are many opportunities to come back from strike outs. In investing, the opportunities to prove your worth are limited, the strikeouts are far more costly, and clients—unlike fans—are less forgiving and unwilling to “wait until next year”.

*Derek Izuel, CFA
Chief Equity Officer
HighMark Capital Management, Inc.*

¹ Richard C. Grinold and Ronald N. Kahn, *Active Portfolio Management, A Quantitative Approach for Providing Superior Returns and Controlling Risk* (New York: McGraw-Hill, 1999).

² "Beta" here is defined as a measure of the portfolio's volatility versus a benchmark or index.

³ Grinold published an earlier version of the theory, and the importance of breadth, in "The fundamental law of active management," *The Journal of Portfolio Management*, (Spring 1989): 30.

This is a publication of HighMark Capital Management, Inc. (HighMark). This publication is for general information only and is not intended to provide specific advice to any individual or institution. Some information provided herein was obtained from third-party sources deemed to be reliable. HighMark and its affiliates make no representations or warranties with respect to the timeliness, accuracy, or completeness of this publication and bear no liability for any loss arising from its use. All forward-looking information and forecasts contained in this publication, unless otherwise noted, are the opinion of HighMark, and future market movements may differ significantly from our expectations. HighMark, an SEC-registered investment adviser, is a wholly owned subsidiary of MUFG Union Bank, N.A. (MUFG Union Bank). HighMark manages institutional separate account portfolios for a wide variety of for-profit and nonprofit organizations, public agencies, public and private retirement plans, and personal trusts of all sizes. It may also serve as sub-adviser for mutual funds, common trust funds, and collective investment funds. MUFG Union Bank, a subsidiary of MUFG Americas Holdings Corporation, provides certain services to HighMark and is compensated for these services. Past performance does not guarantee future results. Individual account management and construction will vary depending on each client's investment needs and objectives. **Investments employing HighMark strategies are NOT insured by the FDIC or by any other Federal Government Agency, are NOT Bank deposits, are NOT guaranteed by the Bank or any Bank affiliate, and MAY lose value, including possible loss of principal.**

Alpha is a measure of the active return on an investment, the performance of that investment compared to a suitable market index. An alpha of 1 means the investment's return on investment over a selected period of time was 1% better than the market during that same period, an alpha of -1 means the investment underperformed the market. Alpha is one of the five key measures in modern portfolio theory.