Asset Manager Insights

High-conviction strategies: Investing like you mean it

While the active/passive debate carries on across the asset management industry, it represents only one of the questions financial professionals face when constructing portfolios for clients. Other challenges include "closet" index funds, the pressure to select outperforming managers and clients who may attempt to time the market. Even if a professional is able to steer a client away from the latter approach, he or she must still provide guidance regarding an effective combination of active and passive, or another approach to portfolio management.

With 2017's extraordinary returns across international equity markets, investors could easily justify even more enthusiasm for passive investing. Why pay for active management when the MSCI EAFE Index is up over 25% and the MSCI Emerging Markets Index rises 37%? At the same time, most investors know that 2017's high returns and low volatility were exactly that — extraordinary.

With the market turbulence in early 2018 adding another challenge to those noted above, we think it is valuable to take a closer look at a subset of the investment universe we call "high-conviction" (HC) active strategies and assess whether they offer measurable benefits versus index funds or low tracking error active strategies.

Defining the high-conviction universe

In this analysis, we used composite data as reported to Morningstar[1] and focused on international developed markets and emerging markets. To establish a methodology for identifying HC strategies, we used five different characteristics: tracking error, beta, R-squared, upside/downside capture and active share. The table below shows the filtering guidelines for each characteristic.

Characteristic	Guideline
Tracking error	3-year tracking error in the top 20% more than 50% of the time
Beta	3-year beta in the top and bottom 10% more than 50% of the time
R-squared	3-year R-squared in the bottom 25% more than 50% of the time
Upside/downside capture	3-year upside/downside capture in the top/bottom 20% more than 50% of the time
Active share	Top decile of full universe sorted by highest to lowest active share

[1] Institutional separate accounts, gross of fees, with an inception date prior to 01/02/2012. Statistics for the HC universe and all subsets are calculated using the median monthly returns from 01/01/1998 to 12/31/2017. Composite information is self-reported to Morningstar by the managers and has not been independently verified.

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From here, we established an overall HC universe by including composites that appeared in three out of the five groups created by these filtering guidelines.[2] For the purposes of this discussion, strategies that fell outside of these filtering guidelines will be referred to as "non-HC" strategies.

We recognize the concern that the same historical data used to create the HC universe was also used to measure its performance. We strove to mitigate this bias by imposing a high frequency (greater than 50% for all characteristics but active share) on how often a strategy was required to meet three of the five filtering guidelines. This gives us greater confidence the strategies selected would have populated the HC universe even if other time periods were used for filtering. Survivorship bias also affects our results, as underperforming composites may have exited the universe. In a sense, however, survivorship bias gives our results a more conservative tilt due to the upward pressure on the surviving strategies to outperform the benchmark and their peers.

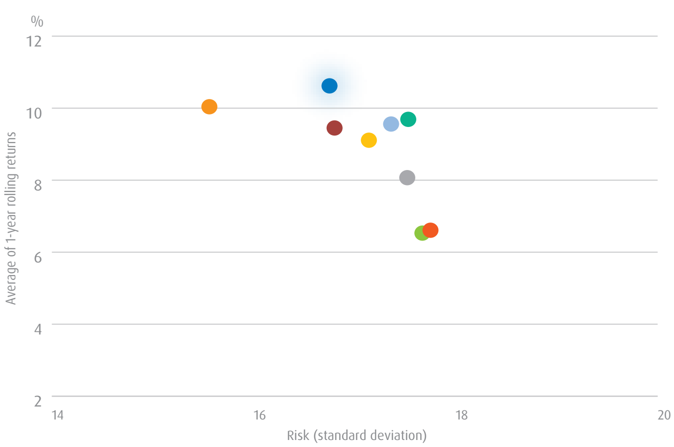
> All five filtering guidelines revealed HC strategies had higher average returns and lower standard deviation over rolling windows versus the full universe, the benchmark and an ETF[3] designed to track the benchmark.

Risk/return observations

In order to evaluate the HC universe, we examined the historical risk/return trade-off using an average of one- and three-year rolling returns versus annualized risk (standard deviation). All five filtering guidelines revealed HC strategies had higher average returns and lower standard deviation over rolling windows versus the full universe, the benchmark and an ETF[3] designed to track the benchmark. Risk/return data is shown in the following charts:

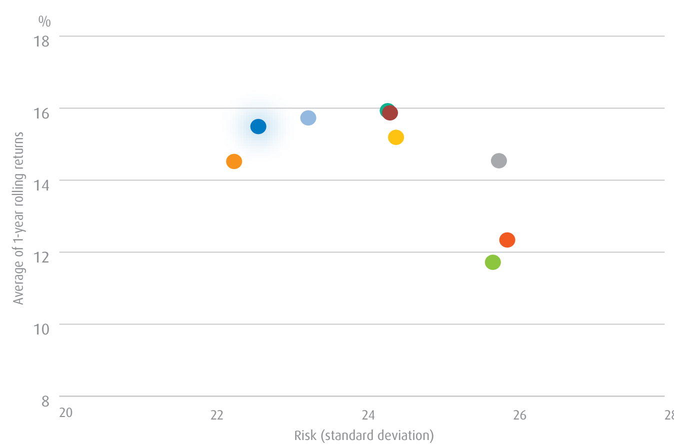
International developed market equities

Risk / return trade-off 1-year rolling data



Emerging market equities

Risk / return trade-off 1-year rolling data

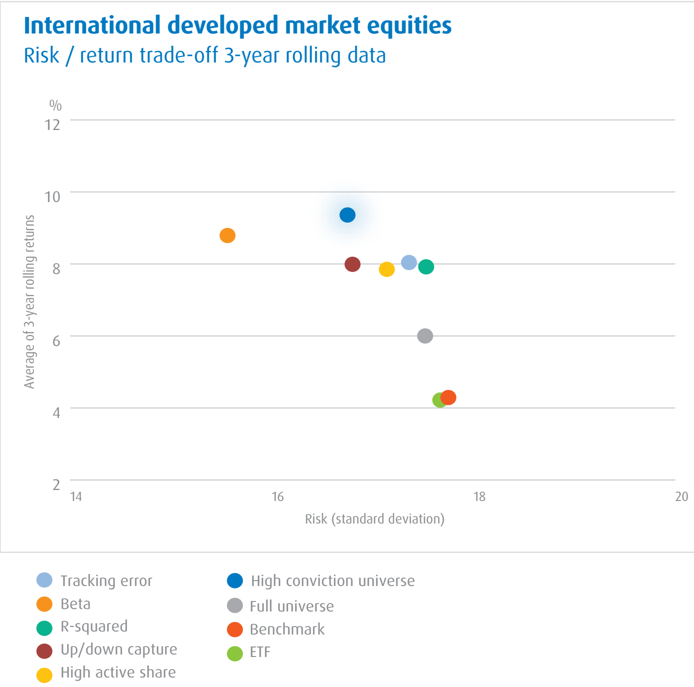


- Tracking error
- Beta
- R-squared
- Up/down capture
- High active share
- High conviction universe
- Full universe
- Benchmark
- ETF

Chart sources: BMO Global Asset Management, Morningstar Direct and Bloomberg L.P.

[2] In international developed markets, 22 out of 141 strategies met the criteria. In emerging markets, 26 out of 132 strategies did so.

[3] iShares MSCI EAFE ETF (inception 08/14/2001) and iShares MSCI Emerging Markets ETF (inception 04/07/2003). For the period prior to inception, the corresponding index was substituted to build a performance record of the same length as the other composites used in this analysis.



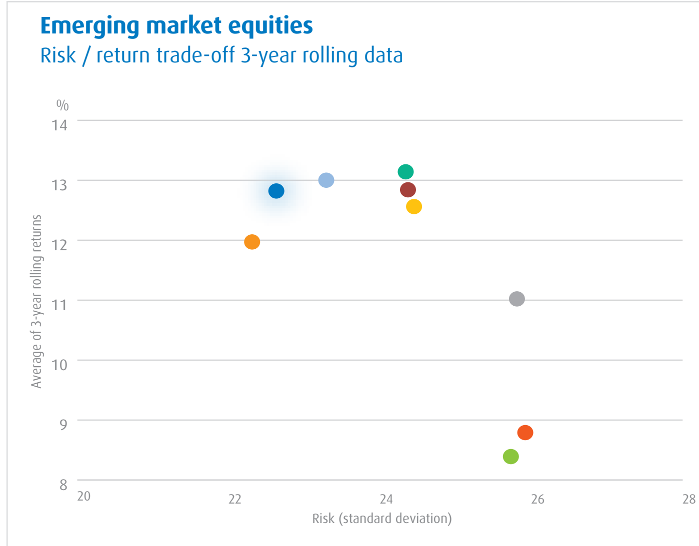


Chart sources: BMO Global Asset Management, Morningstar Direct and Bloomberg L.P.

Downside risk mitigation

HC strategies also offered advantages in terms of downside risk mitigation. We looked at the percentage of time three-year returns were in the bottom quartile of the full universe and found that HC strategies appeared in the bottom quartile less often than the non-HC strategies. Moreover, the maximum drawdown for HC strategies over 15 years was notably smaller than that of non-HC strategies (-34% versus -41% for international developed markets and -32% versus -47% for emerging markets). This result may be a bit surprising to investors who might understandably expect the median HC strategies to experience wider performance swings.

HC strategies also offered advantages in terms of downside risk mitigation.

Getting in and staying in

While they delivered top-quartile performance approximately 50% of the time, HC strategies did at times underperform their peer universe. We found that HC strategies exhibited a broader ranking dispersion and their performance sometimes placed them in the bottom quartile. However, that dispersion did not hurt longer-term performance in international developed markets, as the probability of delivering top-quartile performance in the three years following bottom-quartile performance was higher for HC strategies (55%) than for non-HC strategies (24%).

Conversely, the probability of delivering bottom-quartile performance in the three years following top-quartile performance was lower (26%) than that of non-HC strategies (38%). Within emerging markets, the difference in improving/declining probabilities was narrower between HC and non-HC strategies, but HC strategies still showed a strong performance advantage over the last 20 years, delivering top-quartile performance nearly 50% of the time versus 26% for non-HC strategies.

To provide a wider comparison, we added ETFs to our probability calculation; however, these vehicles never ascended to the top quartile and thus could not provide improving/declining probability data.

International developed markets	Average percentage of time in top quartile	Average probability of improving performance[4]	Average probability of declining performance[4]
HC strategies	53%	55%	26%
Non-HC strategies	23%	24%	38%
Emerging markets			
HC strategies	48%	40%	33%
Non-HC strategies	26%	30%	36%

[4] Improving performance is defined as delivering top-quartile performance three years after delivering bottom-quartile performance; declining performance is defined as delivering bottom-quartile performance three years after delivering top-quartile performance. Past performance is not a guarantee of future results.

These results suggest that an underperforming HC strategy may present a buying opportunity for new investors. At the same time, the data underlines the importance of patience for current investors in an HC strategy. If an investor is confident in an HC manager's process, it is inadvisable to steer away from that strategy during tough times, due to the greater probability of a strong rebound versus the wider universe.

Lastly, we reviewed strategies in the top quartile for performance over three-, five- and 10-year periods. These results suggest that the HC universe could help investment decision-makers identify active strategies capable of outperformance over the long term. Within international developed-market equities, 69% of HC strategies delivered top-quartile performance over ten years, while just 15% of non-HC managers did so over the same time period. HC strategies in emerging markets displayed a similarly attractive probability of long-term outperformance versus non-HC strategies.

These results suggest that the HC universe could help investment decision-makers identify active strategies capable of outperformance over the long term.

International developed markets		3-year	5-year	10-year
HC strategies	Number in top quartile	8	11	11
	Percent in top quartile	36%	50%	69%
Non-HC strategies	Number in top quartile	21	18	12
	Percent in top quartile	22%	19%	15%
Emerging markets				
HC strategies	Number in top quartile	5	8	7
	Percent in top quartile	24%	38%	70%
Non-HC strategies	Number in top quartile	23	20	11
	Percent in top quartile	25%	22%	17%

As of 12/31/2017. Past performance is not a guarantee of future results.

The graphs below further illustrate the benefit of HC strategies versus non-HC strategies over time. On a rolling 3-year basis, a sizable percentage (generally more than 50%) of international developed-market HC strategies appeared in the top quartile (chart 1) while generally less than 30% were in the bottom quartile (chart 2). The percentage of non-HC strategies in the top and bottom quartile was steadier over time, but a significantly lower percentage made the top quartile (chart 1) while a larger percentage appeared in the bottom quartile (chart 2). HC strategies thus offered an attractive probability of outperforming non-HC strategies. In emerging markets, we saw a similar trend in the percentage of HC strategies appearing in the top quartile over time (chart 3). However, a higher percentage of emerging-market HC strategies also appeared in the bottom quartile, especially early in the period covered by this analysis, and we observed the wider range of this statistic over time (chart 4).

Chart 1: Intl. EQ – percentage of universe in top quartile

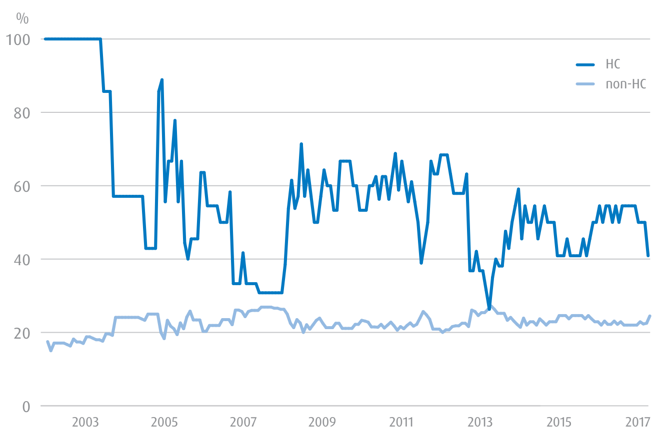


Chart 3: EM EQ – percentage of universe in top quartile

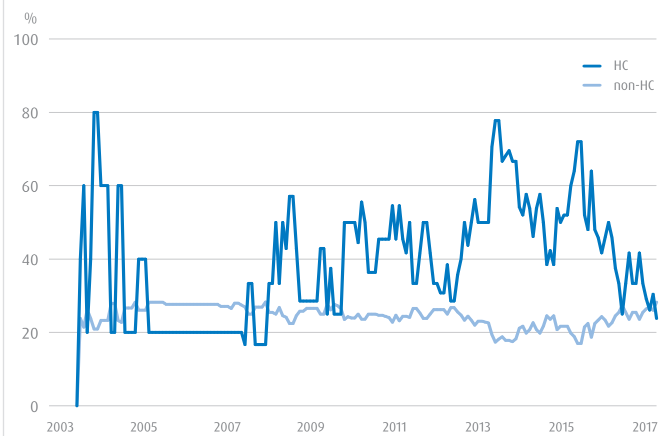


Chart 2: Intl. EQ – percentage of universe in bottom quartile

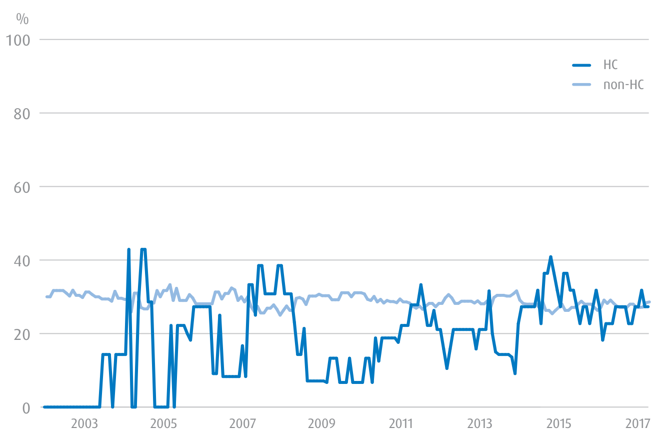


Chart 4: EM EQ – percentage of universe in bottom quartile

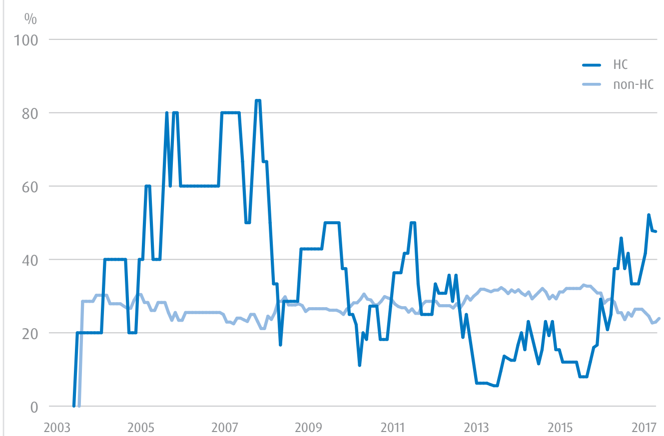


Chart sources: BMO Global Asset Management, Morningstar Direct and Bloomberg L.P.

Patience preferred

Most financial professionals are well acquainted with clients' tendency to chase performance. Consequently, it is perhaps even more important to help clients understand that the value of HC strategies is best seen from a long-term perspective. Investors with a shorter time horizon or a low tolerance for bottom-quartile performance may have more difficulty with HC strategies. As we've seen, a short-term view of underperformance could overlook a buying opportunity while getting impatient with an HC manager could result in forfeiting a rebound.

Professionals may also have to address client perceptions regarding manager selection. If an HC strategy is in the bottom quartile, a client may question its presence in his or her portfolio unless some larger context is provided. We believe this research illustrates the benefits of a longer-term philosophy by providing quantitative evidence that getting in and staying in during times of underperformance has a good probability of paying off.

> These results suggest HC strategies can help financial professionals add value in both portfolio construction and manager selection.

For clients able to understand and accept some variation in short-term performance, HC strategies offer the opportunity to improve their portfolio. The table below illustrates the advantages of adding exposure to HC strategies in allocations to international developed markets and emerging markets. For comparison purposes, we also added a sample allocation of 50% HC strategy/50% ETF[5] (designed to track the index).

International developed markets	1-year average total return	3-year average total return	Annualized standard deviation	1-year downside (5% CVaR)
ETF	6.53	4.22	17.67	-40.57
HC	10.62	9.36	16.75	-32.89
50% ETF/50% HC	**8.53**	**6.77**	**16.93**	**-36.75**
Emerging markets				
ETF	11.72	8.39	25.73	-43.20
HC	15.49	12.82	22.63	-37.88
50% ETF/50% HC	**13.61**	**10.63**	**23.96**	**-40.49**

Rolling one- and three-year returns gross of fees. Conditional value at risk (CVaR) expresses the average expected loss given a certain probability level (in this case 5%) and is calculated as the average of the worst 5% of historical annual returns. Past performance is not a guarantee of future results.

In both markets, the 50/50 allocation provided excess return, notably more than 2% over a three-year period, while reducing volatility versus the ETF alone. These results suggest HC strategies can help financial professionals add value in both portfolio construction and manager selection. As an additional benefit, the HC universe can isolate truly active strategies from "closet" index strategies and thus help clients optimize their fee budget for active management.

[5] iShares MSCI EAFE ETF (inception 08/14/2001) and iShares MSCI Emerging Markets ETF (inception 04/07/2003). For the period prior to inception, the corresponding index was substituted to build a performance record of the same length as the other composites used in this analysis.

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In closing

Our first task in this analysis was to develop a framework for identifying HC strategies. Upon achieving this, we found that HC strategies displayed the following characteristics:

- Strong risk/return profile
- Downside risk mitigation
- Higher probability of outperforming versus non-HC strategies over the long term
- Higher probability of rebounding after periods of underperformance

When combined with an index-tracking ETF in a 50/50 allocation, HC strategies delivered material risk/return benefits. A sample allocation like this could serve as a starting point, from which a financial professional can explore solutions tailored to a client's return objectives and risk tolerance. Given the results we observed here, we think it is a good time to start a conversation about HC strategies.

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In international developed markets, 22 out of 141 strategies met the analysis criteria. In emerging markets, 26 out of 132 strategies did so.

International developed markets data was filtered on the Morningstar Foreign Large Blend category. Foreign large-blend portfolios invest in a variety of big international stocks. Most of these portfolios divide their assets among a dozen or more developed markets, including Japan, Britain, France and Germany. These portfolios primarily invest in stocks that have market caps in the top 70% of each economically integrated market (such as Europe or Asia ex-Japan). The blend style is assigned to portfolios where neither growth nor value characteristics predominate. These portfolios typically will have less than 20% of assets invested in U.S. stocks.

Emerging markets data was filtered on the Morningstar Diversified Emerging Markets category. These portfolios tend to divide their assets among 20 or more nations, although they tend to focus on the emerging markets of Asia and Latin America rather than on those of the Middle East, Africa, or Europe. These portfolios invest predominantly in emerging market equities, but some funds also invest in both equities and fixed income investments from emerging markets.

Morgan Stanley Capital International Europe, Australasia and Far East Index (EAFE) is a standard unmanaged foreign securities index representing major non-U.S. stock markets, as monitored by Morgan Stanley Capital International (MSCI).

The MSCI Emerging Markets Index is a market capitalization weighted index comprised of over 800 companies representative of the market structure of emerging countries in Europe, Latin America, Africa, Middle East and Asia. Prior to January 1, 2002, the returns of the MSCI Emerging Markets Index were presented before application of withholding taxes.

Investments cannot be made in an index.

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