Rethinking the approach to investing in equities

Pranay Gupta, CIO for Asia at Lombard Odier, believes investors can achieve greater returns with less risk if they accept that the traditional one-size-fits-all approach has become obsolete

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Conventional wisdom holds that it is prudent to invest in equities as the performance of equities is viewed as a proxy for economic growth. Investing in equities is also seen to help protect the purchasing power of assets from inflation by earning the equity risk premium above a cash investment.

A similar logic is generally articulated for investing a portion of one's total equity exposure in emerging markets – they are higher-growth economies and the investment earns extra return above the developed-market equity risk premium.

So far so good… but why is it then that most pension funds face asset-liability gaps because of their equity exposure?

I propose here that while investment in equities is appropriate, the investment of this allocation is critically flawed in four respects.

Firstly, who decided that the optimal allocation of equity investment across global equities should be based on the size or market capitalisation of the equity market, and not on the best risk-reward trade-off?

Today, adhering to the conventional approach means investing about 50% in US companies, 25% in European companies, 10% in Japan, and only the remaining fraction in emerging markets.

However, the allocation of equity capital should instead be done on a risk-managed basis, where one is controlling the contribution to risk from each region in the portfolio, and getting the best risk-reward trade-off.

Today, that means having a risk-diversified portfolio, with roughly equal amounts of risk coming from the US, emerging markets and others (including Japan, Australia etc). This allows the same equity exposure and return premium as a conventional portfolio but with much less drawdown risk.

Secondly, investors often take a binary view of investing in equities either passively or actively. But isn't there room for both in a portfolio?

Theoretically, one should choose active management in the portfolio component where the dispersion of stock returns is high (i.e. where there are distinct good and bad stocks) and should choose passive management where dispersion is low (where all stocks move together, so an active manager cannot get additional alpha by picking good stocks).

As stock dispersion in the US is about half that in emerging markets, rather than choosing either a passive or active investment style across global equities, one could go passive or semi-passive in US equities and choose active management in Asia and emerging markets.

Thirdly, even when one allocates within global equities by risk contribution rather than market cap, and chooses active versus passive management where appropriate, the resulting portfolio still has a high degree of volatility compared to a cash return requirement. How does one manage that?

Unlike both the US and European markets, Asia is a diverse set of 15 countries, each with its own economic cycle and market characteristics. While it is possible for an investment manager to follow a single investment process for the US and European markets, this is not the best way to invest assets in Asia. The diversity of characteristics across Asian markets demands a multi-strategy investment approach to create lower volatility of return.

Lowering volatility

Analysts and portfolio managers have flip-flopped between a regional-sector and country-driven approach to Asia. A multi-strategy approach that incorporates both of these approaches as independent sources of alpha, and also incorporates other alpha sources, enables the additional risk premium from Asia/emerging markets to be harnessed while substantially lowering the volatility of return.

Finally, investors tend to view systematic-quantitative processes and fundamental-judgmental processes as mutually exclusive, applying across the equity universe the one they see as better.

Quantitative processes are naturally suited to universes where the amount of information is large, where the market is efficient and where the breadth is high. This is in the case of the US. Fundamental processes are suited to universes where dispersion and volatility are high, the market is segmented and fragmented, information is unstructured and breadth is low. This is the case of Asia and other emerging markets.

Perhaps there is space for both to co-exist in a global portfolio – a systematic US equity component and a fundamental Asian equity component. Investors who mix the two – applying quantitative screening and then fundamental judgment in a single investment process – lose the advantages of both techniques.

At the end of the day, all plan sponsors invest in global equities to hedge against inflation but end up unwittingly taking on more drawdown risk than they perhaps have tolerance for.

The worst case is when they do this by investment in passive global equities based on a market-cap-weighted benchmark. Close behind, the second worst scenario is choosing an active global equity manager with a single investment process.

At Lombard Odier, our people who manage assets have also been plan sponsors. They are likely to have a better understanding of the divide that exists between plan sponsor requirements and asset manager services, as well as between conventional academic wisdom and the practical constraints of managing assets.

In essence, they understand that it is still possible to achieve the same degree of equity exposure as the conventional approach but with less risk and greater return. This is done by managing investments, using risk allocation rather than market-cap allocation, judiciously choosing where to go active versus passive, and applying fundamental and systematic processes where appropriate.

A one-size-fits-all approach is obsolete. The sooner we all recognise that, the more successful we are likely to be in managing both risk and return in a diverse global world. ■