Trade-off between return, volatility and cost

With any investment there is invariably a trade-off between return, volatility and the cost of that investment. Recently there has been significant discussion about active management and its inability to outperform benchmarks, which in turn has led to a rising popularity in index funds and exchange traded funds. We have also seen the introduction of smart beta exchange traded funds, which attempt to add incremental excess returns (i.e. alpha) above a benchmark (i.e. beta) at relatively low cost.

The issue of active versus index raises a question for an investor: does active management lead to superior returns and what is the cost of obtaining those returns relative to cheaper index based products.

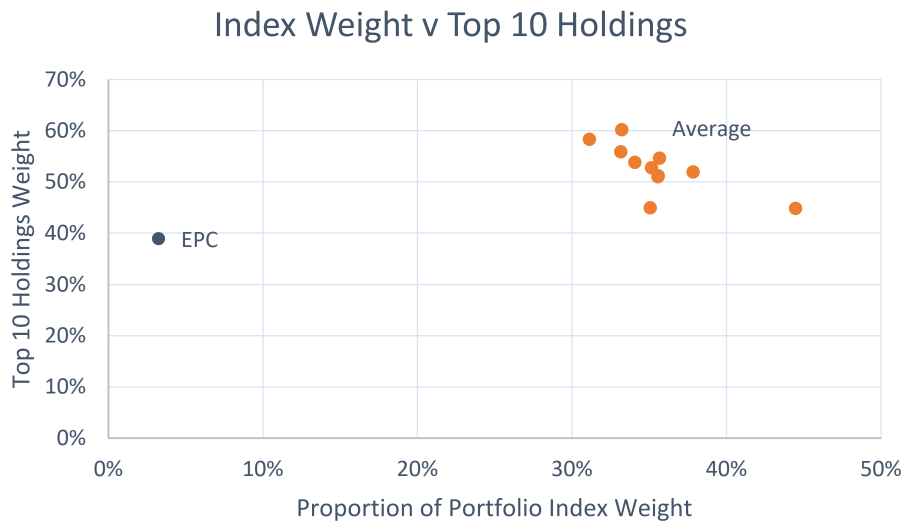
Paying management fees is warranted if a manager can add meaningful excess returns after costs with acceptable risk. However, if active management cannot exceed a benchmark or the return stream is too volatile, then an investor is likely to seek alternative investments. Put simply if an active manager hugs an index and produces index type returns before fees, then it becomes difficult for the manager to justify an active fee structure. However, if a manager is prepared to position the portfolio such that it is materially different from the index, but the resulting returns are inherently volatile, then the investor requires a higher degree of risk tolerance to remain invested.

At Equus Point Capital (EPC) we are index unaware. We are prepared to construct portfolios that bare no relationship to stock index weights or sector index weights. We are entirely focused on producing quality alpha under a risk controlled framework.

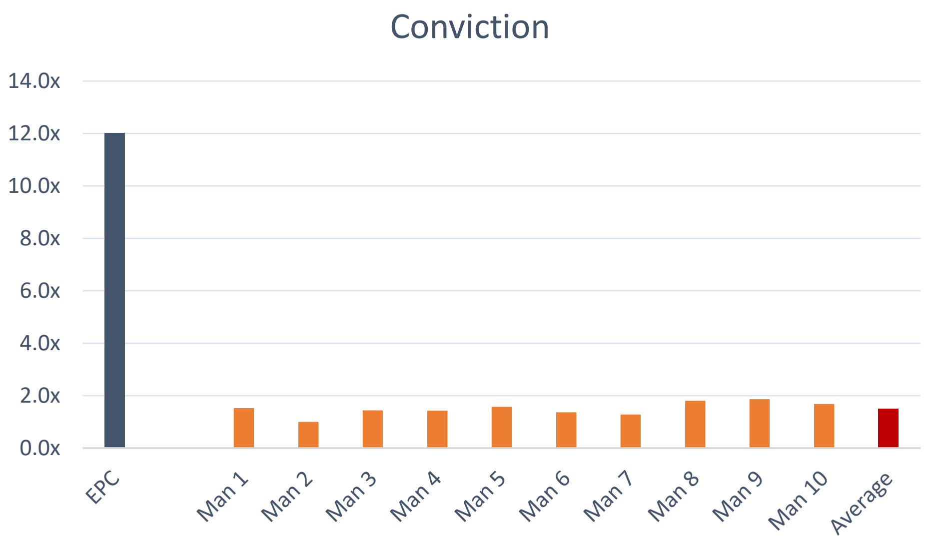
In the following charts we have compared the publicly disclosed top ten positions as at 30 June 18 from prominent and well known active managers (managers A to K). We would highlight that these funds are long only, while at EPC we take both long and short positions depending on the market opportunities.

In the first chart we have illustrated the cumulative index exposure and cumulative portfolio exposure of each manager’s top ten holdings. On average these managers had some 53% of their respective portfolios in their top ten holdings. These holdings had a cumulative index weight of 35%.

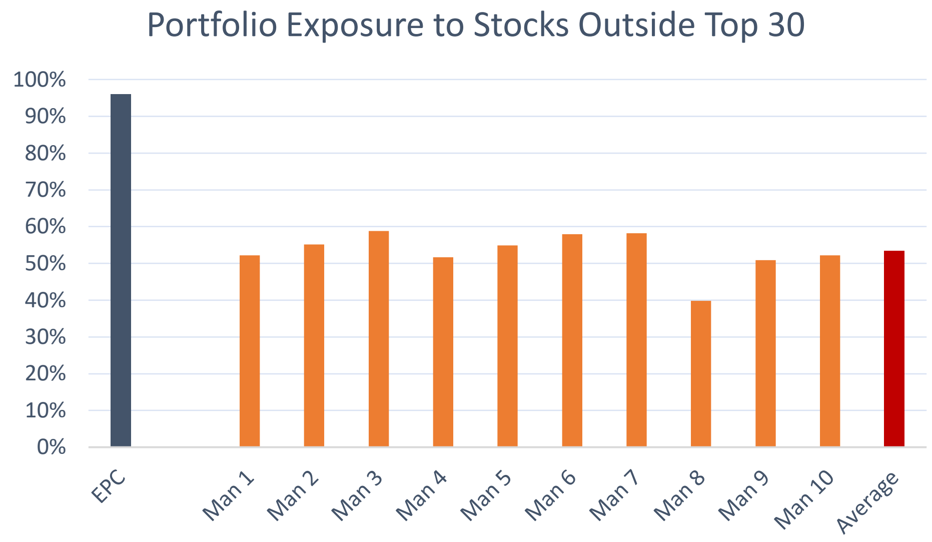
In contrast EPC top ten holdings represented 39% exposure (implying more effective diversification) and the underlying exposure to index weighting was just 4%. Put simply we are not index huggers and we are prepared to take positions that do not follow traditional or standard portfolios.



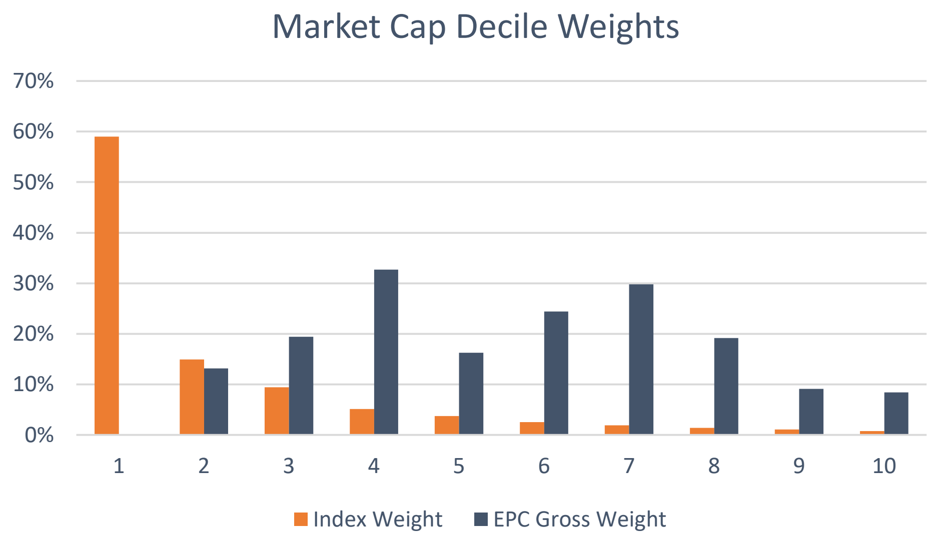
To further illustrate the non-index hugging positioning of EPC, the following chart measures the ratio of portfolio weight to index weight for the same top ten holdings. This represents a measure of portfolio conviction. The traditional funds had a conviction level between 1.0 and 2.0 times index weight for the period of analysis. In contrast EPC had a conviction level of just under 12.0x index weight.



In addition, we do not invest in the larger market cap stocks as we believe these companies tend to be more efficiently priced on average. Deriving meaningful alpha in these stocks is more difficult, and may crowd out better opportunities to derive alpha from mid and small cap companies. As a result, our positions will typically reside outside the top 30 largest stocks by market capitalisation. In contrast the ten high profile managers, we have analysed have just under 54% of their top ten holdings in companies outside the top 30 by market capitalisation.



Finally, we compare EPC's portfolio as at 30 June 18 to the S&P / ASX 200 index weights. While we remain index unaware, we have a natural preference for liquid mid and small cap stocks where we believe we can derive meaningful alpha.



In summary, investors need to assess the ability of active managers to produce meaningful risk adjusted returns. A prerequisite for the generation of meaningful alpha is the manager's willingness to position a portfolio diverging from a predefined universe or index. Index huggers will fail to materially and consistently out-perform a benchmark after fees.

At Equus Point Capital we produce materially different portfolios to any traditional manager or index. We can produce meaningful risk adjusted returns that are uncorrelated to all traditional asset classes providing significant benefits to investor portfolios.

Disclaimer: the quoted performance represents simulated returns from 2000 to 2018 and are based on a systematic risk management process. The strategy employed is strictly for shareholders of Equus Point Capital and no advice for external parties is implied or provided. Past performance is not an indicator of future performance.

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