In the search for “cheap beta,” or market exposure, through indexes and exchange-traded funds (ETFs), investors are increasingly complementing their passive strategies with concentrated approaches that strive to add alpha while still being mindful of risk.

While we recognize that there are many ways to construct a portfolio, there is no single approach to equity investing. In this paper, we discuss concentrated strategies and their role in investors’ portfolios. We also make the case for why now is a good time to consider concentrated solutions as part of a multi-manager approach.

Sometimes, less is more

While most stock funds spread assets across many holdings for diversification, after a certain point, the benefits of diversification diminish. A portfolio that holds 100 or more different stocks is likely to have a more difficult time generating alpha than one

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1 Studies indicate that an equity portfolio needs only 30 to 40 stocks to eliminate most of the diversifiable absolute risk (as defined by the standard deviation of the portfolio). See also Meir Statman, “How Many Stocks Make a Diversified Portfolio?” Journal of Financial and Quantitative Analysis 22, no. 3 (September 1987).
that holds 25, as the impact of individual companies can be outweighed by the performance of the fund’s other holdings.

With concentrated equity strategies—portfolios with only a couple of dozen holdings—managers tend to tackle investment risk more proactively since there is little room for error. Managers rely on in-depth research, digging deeply into the companies’ management, operations and strategies—all of which minimize the risk of unpleasant surprises. And as more investors use ETFs to gain basic beta exposures in their core allocations, many also are looking for managers who promise higher alpha for their “satellite” allocations.

Actively managed large cap growth assets stand at over $1.2 trillion, with institutional assets making up about $747 billion. But while the large cap growth category, like U.S. equities in general, is suffering net outflows, concentrated strategies have fared better. Analyzing the mutual fund universe, concentrated funds bucked the trend and saw positive inflows of roughly $970 million in 2013. Meanwhile, over one-, three- and five-year periods ended in June 2014, concentrated funds saw far less outflows than diversified large cap equity funds.

Is your manager active enough?

Concentrated portfolios typically have a higher “active share,” defined as the percentage of a portfolio that differs from a benchmark index. With long-only equity funds, active share could range from 0% to 100%. At one end, an index fund that seeks to track passive benchmark indexes by holding only those securities in the index through either full replication or a sampling method would have an active share of near zero. For actively managed strategies, the more the fund’s composition differs from the benchmark’s, in both holdings and the percentage weighting of those holdings, the higher its active share. Research on U.S. equity mutual funds by Cremers and Petajisto (2009), the authors who coined the term “active share,” found that high levels of active share were significantly related to subsequent fund outperformance.

More recently, a 2014 study by Cambridge Associates LLC that looked at institutional portfolios found comparable results. Among U.S. large-cap equity managers, the average highest-quartile active share manager outperformed the lowest-quartile manager by 73 basis points (bps), gross of fees. The highest-quartile active share average also compares favorably to each sample’s average manager. The results imply that managers with portfolios that look significantly different from their benchmark have generated better results than their more benchmark-like counterparts.

The benefits of concentration

Holding fewer and larger positions implies more conviction in each investment and, as a result, tends to focus a manager’s attention and reduce the potential for complacency with smaller positions. This greater focus may, in turn, help the manager achieve a deeper understanding of individual positions or make more efficient use of resources. Indeed, several academic studies of mutual funds also have found that higher portfolio concentration is associated with higher relative returns. A 2010 study found that stocks in which managers have the highest conviction often outperformed the rest of the positions in their portfolios and the market. The margin of outperformance ranged from four to 10 percentage points per year from 1984 through 2007, depending on the benchmark. According to a 2007 study, portfolios that focus on the managers’ best ideas generally delivered strong returns without added risk.

Managers take a variety of approaches in running a concentrated strategy. Some may take a deep value approach by buying stocks that are trading below their intrinsic value and patiently waiting for a turnaround. Others may take an active role and influence company management in other ways to maximize their return on investment. Still others may focus on steady or high-growth franchise companies guided by strong management teams that they believe will generate attractive returns. In general, managers tend to hold companies they believe will grow significantly over time. As a result, investors should understand that managers who follow these strategies sometimes invest in out-of-favor sectors and may lag the overall market for periods.
A key part of managing a concentrated strategy is risk management. While concentrated portfolios may appear more volatile than broadly diversified portfolios, recent research suggests otherwise. In 2009, Morningstar examined 299 equity funds with 40 or fewer stocks and concluded that concentrated funds are not more volatile than highly diversified funds on average.\textsuperscript{9}

At J.P. Morgan, we aim to be concentrated in the number of stocks, but diversified in the types of risks we take. For example, we prefer to balance how much individual stocks are contributing to the portfolio’s overall tracking error. While we may have strong conviction in a stock or group of stocks, such as biotech, if those stocks are typically volatile, they would represent smaller weightings in our portfolios. If one of our top holdings declines, that shouldn’t affect the performance of the other stocks, which, over time, should offset any individual disappointments. We also analyze sector, industry, factors and style weightings to ensure that they are broadly represented across the portfolio.


Recent market correction creates attractive entry points

The sharp rotation out of growth stocks earlier this year has provided an attractive entry point for equity strategies with a high-growth focus. In the spring of 2014, former market leaders, such as biotechnology and Internet-related stocks took big hits as investors shifted to safer, dividend-paying stocks, such as utilities and telecom stocks. As shown in Exhibit 1A, the Russell 1000 Value Index outperformed the Russell 1000 Growth Index by 3.4% in March, representing a nearly two-standard-deviation event in performance differentiation between the two styles since the technology bubble in January 2003. And within the growth index itself, the slowest growers outperformed the fastest growers by about 10% (Exhibit 1B). Since there were few, if any, changes with companies’ underlying earnings, we believe the correction was overdone and provides an attractive entry point for investors. Historically, when there is a multiple-contraction event, investors typically compress the multiples of high-growth stocks first, but once their concerns start to wane, multiples can rebound—in some cases very quickly.

Sentiment shifted in March, leading to a sharp rotation out of growth stocks...

EXHIBIT 1A. MONTHLY RUSSELL GROWTH VS. RUSSELL 1000 VALUE TOTAL RETURNS (2003 TO 2014)

...and within the Russell 1000 Growth, high-growth stocks underperformed

EXHIBIT 1B. RETURN FOR THE RUSSELL 1000 GROWTH, BY GROWTH QUINTILE (MARCH 1 TO APRIL 30, 2014)

Note: Quintiles are broken out using the I/B/E/S Long Term Growth Forecast. The quintiles are sector-neutral returns and are equal weighted.

Source: J.P. Morgan; data as of June 30, 2014. Past performance is not a guarantee of future results.
Greater focus, greater insights

With greater focus, comes greater insights. Through the process of evaluating businesses, managers who run concentrated strategies get to know the companies very well. By virtue of following fewer companies, managers have greater insights into the underlying businesses and broader trends. Our research team looks for underappreciated growth opportunities. In particular, we look for some change in the status quo specific to an individual company, an industry or within the industry’s value chain.

One sector undergoing rapid change is the mobile Internet, or the fourth major technology wave. We believe the convergence of broadband wireless, Internet accessibility, smartphones and all the services that get wrapped around them is dramatically changing the way consumers interact with businesses and vice versa. Over the past 40 years, information technology has gone through waves of innovation, with each period building off the advancements of the previous one. In the 1980s, IBM dominated the mainframe computer wave. In the 1990s, Microsoft promised to put a computer in every home, giving rise to the personal computer (PC) wave. The prevalence of PCs subsequently provided the infrastructure for the third wave, the Internet, which spurred companies to develop websites and e-commerce businesses during the early 2000s. Exhibit 2 illustrates the evolution of information technology from mainframe computers to mobility and cloud computing, based on the market capitalizations of the largest technology companies from 1980 to 2014.

Going forward, new technologies are likely to evolve further into the “Internet of things” as an unprecedented number of devices connect to the Internet. That will, in turn, create new opportunities for the companies that have sustainable competitive advantages in those markets.

Stock prices are driven by earnings growth over the long term, not multiple expansion

By any short-term valuation metric, many of the stocks that are in concentrated portfolios may look expensive. But investors should also consider the company’s potential earnings growth trajectory. If “earnings” in the price-to-earnings (P/E) ratio of a stock sharply increase over time, then the stock isn’t all that expensive. In 2004, for example, Google went public at $85 a share while broadband penetration in U.S. households was roughly 25%. As more households gained broadband Internet access—penetration increased to about 55% by 2007—people sharply increased their Internet searches. As a result, Google’s stock price more than quadrupled in price by 2007 (Exhibit 3A, next page). Today, there is a similar pattern with Facebook, which is currently trading at about 40 to 50 times earnings, but is following a similar growth curve to Google’s in the early 2000s (Exhibit 3B, next page).

As information technology evolves to the fourth wave, investors can find new opportunities

EXHIBIT 2: INFORMATION TECHNOLOGY EVOLUTION

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The companies showed above are illustrative and discussion purposes only. It should not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities listed above.
Portfolio construction

With a core-satellite strategy, concentrated equity portfolios are typically used as the “satellite” allocation to gain more alpha. Doing so takes advantage of the broader trend toward indexing as more institutional managers use a largely passive core portfolio coupled with more concentrated bets to maximize alpha in a cost-efficient way by using one or more concentrated managers.

The universe of such managers is not huge, but the level of diligence that we believe is necessary to properly evaluate them is just as stringent than any other strategy. Since managers of concentrated equity portfolios are placing larger bets with fewer companies, analyzing their research acumen, process and discipline is critical to becoming comfortable with their stock-picking ability as well as their risk-management process. Not only is it important to have a strong research platform that has the bottom-up approach that can drive the insights for stock selection, but it is also important that the manager diversifies risks across sectors and securities. The managers should have demonstrated an ability to achieve market-beating results over long periods. We believe this is a skill that is largely driven by a defined, repeatable investment process applied toward a particular area of focus. While there may be a few bumps along the way, research has shown that the extra attention these fewer holdings demand may deliver solid, even superior, returns in the long run.

Sources: J.P. Morgan and FactSet; data as of July 2014. Past performance does not guarantee future results. The securities highlighted above have been selected based on their significance and are shown for illustrative purposes only. They should not be interpreted as a recommendations to buy or sell. It should not be assumed that other securities in the portfolio have performed in a similar manner.
INVESTMENT INSIGHTS

The case for concentration

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