

Genuinely unconstrained equities:
Stepping outside the style box

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In an era of globalization, and with the specter of deflation in Europe and a slowdown in China, investors are searching the globe for companies that can deliver sustainable growth. In this interview, **Shane Duffy** discusses how international, unconstrained strategies can help investors ramp up their holdings of foreign stocks, in the right way. These strategies, which focus on a manager's highest-conviction stock ideas, regardless of region, sector weight or capitalization, can adapt to an evolving global landscape and potentially achieve excess returns for investors.

In a recent interview, Shane Duffy, Portfolio Manager in the Global Equities Team based in London, shared his thoughts on the case for unconstrained investing and outlined four potential sources of alpha. Shane, who has worked with the same investment team for 15 years and has been involved in multi-region, international investing, explained why a company's country of domicile is often irrelevant to its long-term returns.

Question: As an international manager, what excites you most about the investment landscape?

SHANE DUFFY: As I look at the market today, it's really two things. One is the breadth of investment opportunities in international markets in a number of growth industries. The second is the attractiveness of valuations more broadly, driven by excessive pessimism around prevailing rates of economic growth. On the first point, the U.S. has, of course, been at the forefront of many major growth themes of late—the monetization of the Internet, the shale revolution, biotechnology—but don't forget that many foreign companies play well to these themes, too, and often trade at cheaper valuations. Also, international portfolio managers can access other growth themes that might not be easily accessible in domestic U.S. markets. These might include areas such as factory automation or the emerging market (EM) consumer, where the best companies globally sit outside the U.S.

In recent years, some investors have questioned the need to invest in foreign-focused funds, citing poor U.S. dollar returns from overseas equities and the fact that correlations between U.S. and non-U.S. equities have increased. These investors are also perennially worried about low economic growth outside the U.S. and assume this



Shane Duffy
Managing Director
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can only be bad news for international equities. But, we believe that's an oversimplification. Correlations may be elevated, but international markets have underperformed, valuations are attractive versus the U.S. and versus history and, again, there are some very exciting companies out there. Giving a portfolio manager flexibility to navigate that opportunity set freely makes a lot of sense.

Question: But if U.S. multinational companies are increasingly global, why hold foreign stocks?

SHANE: While a number of U.S. companies have done a good job of globalizing their businesses (think of consumer products or technology companies), Europe, Japan and the EMs are home to many companies that have done a good, if not better, job of diversifying beyond their local markets. Bear in mind also that since the domestic growth rates in parts of Europe and Japan have been poor for a number of years—unlike the more dynamic U.S. economy—companies domiciled in those regions were forced to make overseas investments early on to spur growth.

Volkswagen, for example, has come to dominate the premium car segment in China and in other EMs and is now making a big push into the U.S. market. Another example is Inditex (owner of the Zara brand), once a domestic Spanish clothing retailer, but now one of the most successful global fashion retailers.

The companies we invest in are not exclusively dependent on the revenue, growth profiles or earnings outcomes of the local markets in which they sit. In fact, the country of domicile is often irrelevant to the actual long-term driver of shareholder returns for a company. More important is where they have planted flags, where they have made investments over the last 20 years and where they have been deriving their revenue and earnings.

Question: You mentioned investors worrying about low growth outside the U.S.. How does this affect international strategies?

SHANE: While the headlines that U.S. investors read are frequently troubling, investing internationally is not all about worrying about what the European Central Bank is going to do next or fretting about the unemployment rate in peripheral Europe. Our focus is very much on identifying underappreciated growth or profitability, and there are some fantastic companies in Europe and Asia doing very innovative, exciting things. They have invested beyond their home markets, are delivering attractive returns on capital and have strong, sustainable growth platforms. International investing is about accessing an asset class

where valuations are relatively cheap versus domestic U.S. equities and where portfolio managers can be selective about the companies they want to own within that opportunity set.

The focus on economic growth rates is, in my view, often misplaced. Many tend to think that European or Japanese equity market returns are purely a function of GDP growth. Actually, the relationship between equity market returns and GDP growth is quite poor. That's because the equity markets reflect what corporations are doing, and corporations, by and large, have invested beyond their local markets, so their growth rates have very little to do with what is going on in their home economy.

Question: How do you define “unconstrained?”

SHANE: The word “unconstrained” has become a bit of a buzzword. Within equities, we believe it comes down to giving portfolio managers the freedom to use risk within a portfolio in a way that maximizes their potential to deliver excess returns. From our perspective, we are focusing capital on those stocks where we have the highest conviction and the strongest sense of favorable risk/reward. While some managers might hold a proportion of their portfolio in stocks that overlap with the index, we want to resist the temptation to own stocks for risk-control purposes. In a sense, unconstrained investing represents a stripped down, simplified way of managing money. It's about staying very close to the raw output of our research endeavors and our fundamental analysis and trying to ignore where the index might be telling us to invest.

Question: International strategies often use traditional benchmarks, such as the MSCI ACWI ex-U.S. Index, to evaluate performance. How are unconstrained strategies evaluated?

SHANE: One of the benefits of an unconstrained strategy is that it helps overcome benchmark inefficiencies. If you're buying a strategy that tracks an index closely—either by design or because the manager is a closet indexer—you're inherently making allocations to sectors or regions that might be inflated artificially at that point in time (think financials in late 2007, technology in the late 1990s or Japan in the late 1980s). Almost by definition, you're putting more money to work than makes sense in the most expensive, overrepresented sectors in the benchmark. On a fundamental basis, those sectors or regions that dominate an index are typically unattractive at that point in time because of excessive valuations or unsustainably high profitability. A fundamentally driven manager

should have fairly low expected returns in those sorts of areas, but a benchmark-driven approach with tight risk parameters will mean they still invest in those overrepresented sectors. In fact, our strategy can take meaningful bets against index distortions and can choose not to own stocks in sectors, industries and regions where valuations are elevated, where we think profits are unsustainable or where there is a poor track record in terms of shareholder returns.

Question: What should investors look for in unconstrained strategies?

SHANE: A good mark of an unconstrained manager is one whose active share—defined as the percentage of a portfolio that differs from a benchmark index—is at least 80%, because that suggests a level of differentiation from the benchmark that is very meaningful. And, if that’s married with skill, then, hopefully, that should deliver good results and sustainable excess returns. This is important because concentration tells you nothing about skill. Investors should understand the decision-making process that drives the concentration in the portfolio (for example, fundamental stock picking, macro bets, factor bets) and then look for evidence that the manager has proven skill in those areas. Since our international unconstrained strategy seeks to leverage our team’s skills in stock selection in a more focused, benchmark-agnostic strategy, our portfolio consists of our highest-conviction stock ideas. As a result, we typically hold between 40 and 50 stocks and have an active share well north of 80%.

Question: So active share should not be considered in isolation?

SHANE: Correct. While the concept of active share has gotten a lot of attention in the marketplace, it’s important to stress that active share is a measure of risk, and a simple one at that. Whether it translates into excess return is another, more complex issue. The key driver of outperformance for the products that I’ve managed over the years has been stock selection within sectors, helped by a team of dedicated global sector analysts. Our team’s skill set lies in stock selection. The key, then, for our unconstrained strategy is to give free rein to that skill and package it in a more focused way that, hopefully, delivers even better results to clients. We also want to make sure that we’re not embedding other bets or risks with little confidence of being rewarded.

Many of the clients and consultants that we meet are anxious to know whether active share is really just a risk measure. Active share can be driven by sector, factor, region and stock-level bets, so investors want to make sure the portfolio manager is not just using the unconstrained umbrella to take different risks. The key is to look at whether the manager is using the freedom within an unconstrained strategy to give a fuller expression to what it is that he or she is genuinely skilled at doing.

Question: Can you talk about your research process? What sets your process apart from that of other firms?

SHANE: What distinguishes our team is our breadth of resources. We have a team of dedicated, global sector research analysts who are skilled at analyzing stocks within the context of their global industries. These analysts can look at longer-term themes and determine which companies are likely to be the winners and losers within their industries. We also have access to the breadth of research across the entire equity platform at J.P. Morgan Asset Management, which means a deep set of resources in every major region: Europe, the Americas, Asia and the EMs.

Having a regional network in place helps our global sector analysts arrive at well-informed conclusions on the companies they cover, while also helping portfolio managers understand the specific nuances of more locally based, domestically focused companies. The retail sector, for example, looks very different in Japan compared with Europe or the U.S.. We’re particularly fortunate to have a network of analysts in the EMs, which is where a lot of the growth has been coming from for international companies.

Question: Are there any common characteristics that you look for in companies?

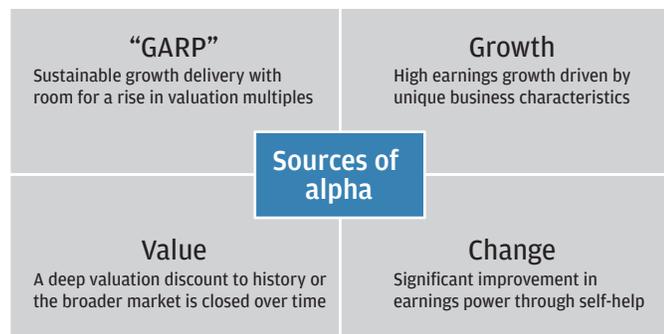
SHANE: Over the years, the marketplace has forced managers into well-defined categories, such as “Large Cap Value,” “Large Cap Growth,” “Small Cap Value,” “Small Cap Growth,” and so on. This applies in the international space as much as it does in the domestic U.S. market. Segmenting managers into investment styles, however, can narrow the opportunity set. A “growth” manager will never own stocks in an industry that is in structural decline, while a “value” manager might ignore entire sectors based on high headline multiples. In building the unconstrained fund, I’ve been very keen to think as

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broadly as possible about the potential sources of alpha. In my view, there are typically four types of investments that can be rewarding for an equity investor (**Exhibit 1**). The lines between them are often fuzzy, but a broad outline would be:

Stock level outperformance is typically driven by one or more of the following factors

EXHIBIT 1: JPMORGAN INTERNATIONAL UNCONSTRAINED



Source: J.P. Morgan; for illustrative purposes only.

- **Growth at a reasonable price (GARP):** High-quality companies with good sustainable growth prospects, trading at reasonable valuations (in other words, the classic "GARP" stocks). These stocks compound earnings ahead of the broader market over time and can enjoy a relative re-rating in terms of valuation, making for a good return.
- **Value:** Companies trading at deep discounts either to their own historic multiples or to their intrinsic values. These stocks perform well when valuations move upward and back in line with longer-term norms.
- **Growth:** The classic growth stock. In some cases, a company may not be cheaply valued on near-term earnings, but, because it is changing or redefining an industry, it is able to grow earnings at a considerably faster rate than the broader market for a sustained period.
- **Change:** The restructuring change story, which is a category that sits in between value and GARP. In this case, a company may have gone through a difficult period, involving a management change or company restructuring. Ultimately, these changes often create and enhance value, and can be an important driver of shareholder returns.

The liberating aspect of unconstrained investing is that you can invest beyond narrow investment classifications. At J.P. Morgan, we are fortunate to have the resources and breadth to explore many opportunities across these various sources of alpha: GARP, value, growth and change.

Question: Can you describe some sectors that fit in to one of the buckets you described?

SHANE: We see a lot of value opportunities in European financials, banks and insurance stocks right now. Many bank stocks, for example, are trading below book value, even though these businesses have good market positions and the prospect (regulations permitting) of earning decent returns on equity over time. For example, Barclays' stock price has been under considerable pressure this year, but the company has a tremendous banking franchise in the UK and is actively restructuring its more volatile investment banking operations. While we recognize the need to be patient with investments like these, we think there's clear unrecognized value. It's also interesting that, in this portfolio, we can have a value investment such as Barclays sitting alongside a growth investment such as Baidu in our top 10 holdings, with both of them large positions. Baidu—as China's principal online search engine—is a business we expect to grow at very high rates over the investment horizon and it is that growth that will drive returns in the stock. In our portfolio, we're trying to exploit opportunities in a way that cuts across the traditional segmentation of managers.

Question: Can you talk about how you diversify your risks?

SHANE: Our research platform, which leverages the breadth of regional and global sector inputs, gives us a natural diversification within the portfolio, since we are able to find ideas across a range of regions and sectors. That's one of the benefits of managing unconstrained portfolios within a broader organization.

When you're an individual or a small team working independently, by contrast, there is a tendency to focus on your areas of expertise. As a result, the portfolio becomes more narrowly focused. That's fine if it's an investment view, but it's not fine if it's simply a function of limited resources and the narrow specialization of the manager. Hunting down the best ideas across regions and sectors leads to a natural diversification within the portfolio.

Question: While “unconstrained” investing has become a bit of a buzzword, your style of investing seems to be genuinely unconstrained given that you’re not afraid to make big sector and region shifts. Can you explain some of the moves that we have seen during the three-year life of the strategy and your rationale behind the portfolio changes?

ANSWER: Our approach is, as you say, genuinely unconstrained, as reflected in the significant shifts that have taken place over the life of the strategy (Exhibit 2). It is important, however, to emphasize that these changes in the sector and region profile of the portfolio have resulted directly from bottom-up stock-picking considerations, as opposed to top-down macro-allocation decisions. For example, when we launched the fund in November 2011, nearly 50% of our portfolio was in European equities (ex-UK), as we could find a number of European domiciled companies with attractive characteristics and significant upside potential. Most of these companies were global in nature, and to that extent were largely immune from growth worries in Europe and enjoyed strong performance in 2012. Since then, we have rotated away from a number of these European multinational companies toward more domestically focused, operationally leveraged companies which stand to benefit from the improving economic conditions and asset

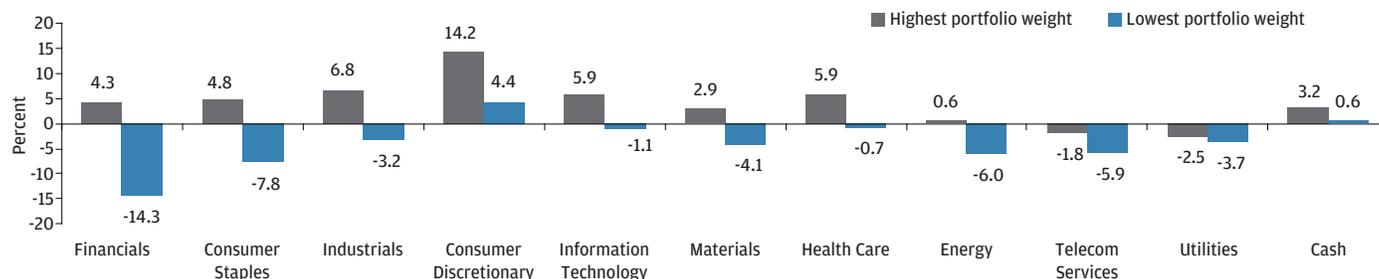
prices in continental Europe. While our weighting in Europe has actually declined to about 34% today, our enthusiasm for the potential of the domestic European equity story and our weighting in stocks oriented toward the European economy is stronger than it has been for some time. So the headline regional allocation does not tell the full story as it cannot show whether your exposure is to global companies that happen to be listed in Europe or to genuinely domestic names.

Another example of a significant change in the profile of the portfolio would be our weighting in financials. At launch in November 2011, we had a 9% allocation to financial stocks (significantly underweight versus the index), which contrasts sharply with our 31% position today. Throughout 2013, we bought more financials, especially in Europe, given the strong improvement in future return prospects of European financials underpinned by a stabilization in credit growth alongside improving capital ratios. In contrast to 2011 when markets were concerned over systemic risks in Europe and a possible breakup of the euro, today those financial companies that have navigated those risks are enjoying supportive central bank policies. Against this positive backdrop, we expect the discounted valuations of financials in Europe to close in the coming quarters.

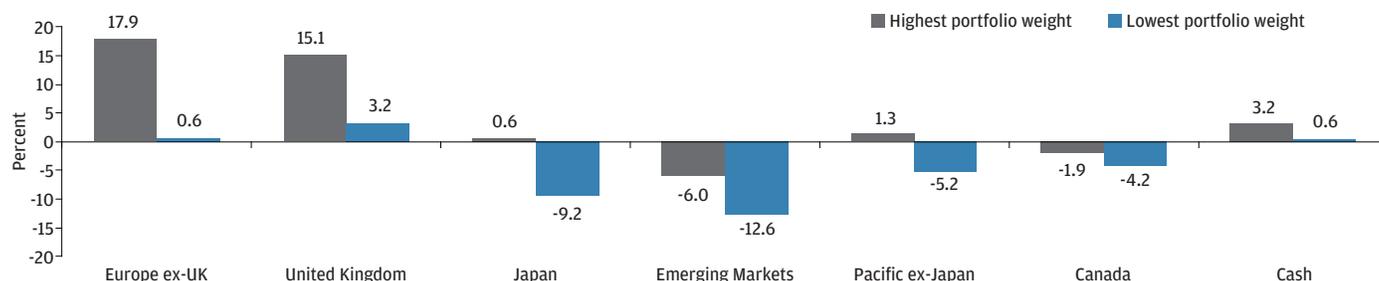
Shifts in sector and region weights reflect a genuinely unconstrained approach

EXHIBIT 2: HIGHEST AND LOWEST MONTHLY PORTFOLIO ACTIVE WEIGHTS* OF SECTORS AND REGIONS FROM 11/30/2011-11/30/2014

2A: SECTOR WEIGHTS



2B: REGION WEIGHTS



Source: J.P. Morgan, Factset; data as of November 30, 2014.

*Active weights relative to the MSCI ACWI ex-US Index

One more example of a big shift in the profile of the portfolio at the sector level, driven by bottom-up considerations, would be the consumer staples sector, where there has been a sharp reduction in our holdings from 15% at the end of 2011 to our current 2% weight. In 2011, “growth at a reasonable price” (GARP) stocks dominated the portfolios as companies in the staples, industrials and information technology sectors showed strong upside potential driven by good growth prospects and attractive valuations. Indeed, those stocks performed very well in 2012. However, we have since reduced positions across a number of these sectors, in particular in consumer staples, as valuations—spurred by investors’ flight to safety—rose to levels that could not be justified by the companies’ growth rates which, if anything, seem to be declining in a number of instances.

Question: How should investors implement unconstrained international strategies in portfolios?

SHANE: Increasingly, we believe an unconstrained strategy can be used as either the core or the satellite portion of investors’ portfolios. When we launched our international unconstrained strategy more than three years ago, the view was more that clients would be interested in employing it as a satellite holding, where they wanted a more actively managed strategy to generate alpha alongside a more index-like core strategy. But, what we find is that investors are increasingly looking for a smaller, targeted equity allocation to work harder for them. They want to tap into the best thinking and strongest ideas of any particular asset management firm and will embrace a more concentrated, higher-conviction strategy as a larger part of their equity allocation. As a result, we believe these strategies can serve both purposes. They can work as an aggressive satellite investment for a client with a

large core allocation consisting of largely passive investments or they can function well for a client with a smaller equity allocation who wants a single manager to work harder in the international space. However the strategy is deployed, though, clients have to be prepared to tolerate the higher volatility of returns that comes with a more concentrated product.

Question: How has your background helped you run unconstrained strategies?

SHANE: I’ve worked with the same investment team for 15 years and have been involved in multi-region, international investing for that entire time. That’s important in terms of having some longevity in the asset class, and in knowing European and Asian markets well. Prior to managing money, I was a global consumer discretionary analyst for seven years. Working as an analyst, particularly in the consumer discretionary industry, provided me with a strong foundation across multiple industries, as well as an ability to understand how new winners and losers can emerge within an industry. It also taught me that there can be hidden value in companies with poor growth prospects, but where there is positive change happening. For the last eight years, I’ve been running an international growth strategy, which now has more than \$1 billion in assets under management. My growth background has helped me focus on the power of compounding and how a change in the earnings numbers—rather than valuation multiples—can often be the biggest driver of shareholder returns over time. Those experiences—both as an analyst covering consumer sectors and as a portfolio manager managing money across regions—have sharpened my skills and stoked my desire to go anywhere to unearth opportunities.

ABOUT THE TEAM

Shane Duffy, managing director, and **Tom Murray**, managing director, are portfolio managers on J.P. Morgan Asset Management's Global Equities Team. Shane and Tom specialize in international equity strategies, with Shane focusing on International Growth and Tom on the core ACWI ex-US strategy. They co-manage the International Unconstrained strategy. Previously, both worked as global sector specialists with Shane covering consumer discretionary stocks and Tom analyzing the

*As of September 30, 2014.

energy sector. The broader Global Equities Team is comprised of six portfolio managers who have an average of 24 years of experience, supported by 10 global sector specialists who, in turn, average 16 years of experience.* In addition, the team leverages the insights and experience of the regional teams—which consists of approximately 200 investment professionals—in the local markets, providing them with an invaluable information advantage.

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