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EQUITIES

Looking Under the Hood: Not All Equity Returns Are Equal

By: Aaron Dunn, CFA | & Bradley Galko, CFA | October 19, 2022

Boston - Investing in portfolios that track benchmark indexes can be a great investment approach when the market is going up. However, in certain market periods when interest rates are rising, inflation is surging and geopolitical tensions are high — 2022 is a good example — having an active manager who can identify leading companies priced at a discount to their intrinsic value may become essential.

Volatile markets underscore the need for identifying such gems, which can be discovered with the right fundamental due diligence. But not all bottom-up, fundamental managers are equal. It's important to know what's driving your manager's underlying returns. What type of exposure do they have? Can they provide downside protection, and will they also be able to deliver on the upside?

Definition of value investing continues to evolve

We believe there is a long runway for traditional value investing, and choosing the right manager matters — particularly in today's market environment. A manager may apply their experience and sector specialization to seek returns through security selection — allocating to stocks at different weights in the portfolio relative to the benchmark. Or they can expose the portfolio to certain common factors that have historically demonstrated the potential to drive stock returns.

As we have discussed in previous blogs, when the definition of traditional value investing evolves, we must focus on offering the most consistent way to generate equity returns over time and through economic cycles.

Look under the hood of your portfolio

The time is ripe to look under the hood of your portfolio to understand what is driving returns and eschew unintended risk. In strenuous economic times like these, we believe looking under the hood can be the best way to help ensure that you are more protected against market downturns.

Security selection and factor exposure also drive tracking error.[1] Regardless of your appetite for low or high tracking error, it's vital to know what is driving the tracking error. Is your portfolio primarily driven by residual volatility[2] or long-term reversal[3] factors? If so, how might it perform across various market environments?

Know what's in your portfolio and why

Within our Value Equity team, we seek to run strategies where roughly between 75% and 85% of returns and risk are driven by security selection. Because of this, we can run relatively low tracking error strategies, despite being concentrated. Regardless of market volatility, we aim for minimal cash exposure in an effort to create true bottom-up, fundamental equity exposure in the broader asset allocation of a portfolio.

Just like managers, not all large value equity strategies are created equal, and not all are truly differentiated in their methods of security selection and generating alpha.[4] That's why it's always essential to know what you own. The right bottom-up investor can unearth those hidden gems, even in rough markets.

Bottom line: Soaring interest rates, elevated inflation and heightened geopolitical worries are all top of mind for investors. There's an urgent focus on generating consistent equity returns over time, regardless of market conditions. Equally important for long-term returns is knowing what drives portfolio return and risk.

[1] Tracking error is the difference in performance between a portfolio and its underlying benchmark.

[2] Residual volatility measures how much a stock price fluctuates relative to a benchmark index.

[3] Long-term reversal is the tendency of a stock with high returns over the past three to five years to underperform relative to a stock with low returns during the same period.

[4] Alpha is the value added by a manager to the portfolio's return relative to the benchmark's return.

All investing involves risk, including the risk of loss.

Risk Considerations: *The value of investments may increase or decrease in response to economic, and financial events (whether real, expected or perceived) in the U.S. and global markets. The value of equity securities is sensitive to stock market volatility.*

Active management attempts to outperform a passive benchmark through proactive security selection and assumes considerable risk should managers incorrectly anticipate changing conditions. There is no guarantee that any investment strategy will work under all market conditions, and each investor should evaluate their ability to invest for the long term, especially during periods of downturn in the market.

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