The Power of Focus

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Hello. My name is Kevin Collins and I'm a senior vice president and client portfolio manager at Alger. As a former analyst and portfolio manager, I understand that alpha is of paramount importance to you and investors—both professional and non-professional alike. Many of us are seeking greater returns than we are currently earning in our personal wealth. We seek outperformance and we need alpha.

To explore how investors source alpha potential, Alger recently partnered in a study with Greenwich Associates, a leading provider of market intelligence. Greenwich surveyed more than 90 of the best known and most highly respected decision-makers in the investment world. The institutional investors they spoke to include public and corporate pensions as well as endowments and foundations. The intermediary group includes analysts, model teams and key decision-makers in the home offices of wirehouses, broker-dealers, RIAs and retirement platforms. The investment consultants are professionals who provide advice to institutional investors on topics such as asset allocation, manager research and performance analysis. The conclusion of this notable study indicates that a significant shifting of client assets to focused portfolios will continue in 2018 and beyond. Many investors believe that focused strategies, portfolios consisting of 50 or fewer securities, can satisfy their need for alpha.

A primary catalyst for interest in focused strategies is investors' contention that in an actively managed portfolio, the portfolio manager's highest conviction holdings, which predominate in a focused strategy, disproportionately drive excess returns. Ninety percent of the study's respondents —nearly everyone—believe this is true. And as someone who has constructed portfolios, I understand why this is the case. One decision we have to make is whether an idea gets into a portfolio. However, an even more important decision is our conviction level for an idea and whether we've done the necessary research to own that position in size.

How did Greenwich Associates arrive at the conclusion that popularity of focused strategies will rise? Over the course of three months, they conducted an in-depth study called The Power of Focus, delving into the use of focused equity strategies in the United States. They explored the rationale for the participants' seeking out focused strategies, the ways in which focused strategies are being incorporated into portfolios and the future outlook for these distinct strategies.

Throughout this discussion, we'll address a number of key findings from the study, including: allocations to focused strategies and how they're being used, why the need for alpha has become so great, why investors believe focused strategies can deliver alpha, the significance of active share and the effect on risk management.

Over three quarters of these key decision makers at America's largest financial institutions believe focused strategies stand a better chance of delivering alpha than diversified strategies. More importantly, investors report that they are increasing allocations to focused strategies. In both institutional and intermediary channels, focused strategies are being employed throughout the spectrum of U.S. equity product categories, either as satellite or core components. This revelation's interesting to us. Investors are using focused strategies in their core components, which suggests that they consider focused strategies a fundamental part of their approach. In terms of categories, U.S. large value and growth equities are common areas where investors deem focused strategies relevant, but they are also using them for mid and small cap allocations.

Among these senior institutional investors and intermediaries, focused strategies constitute between 20% and 30% of total active equity assets. These focused allocations have been increasing over the past 12-18 months. Additionally, more than half of these investors expect their interest in focused equity products to accelerate in the next 24 months.

These numbers demonstrate that investors are coming to understand the potential benefits of focused strategies and they are willing to take action in the pursuit of alpha. We've already established that the need for alpha is critical. Here's some more color on the situation. Funding levels for the largest public pensions have fallen from 82% to 74% between the pre-financial crisis year of 2006 and today, 2017, despite a nine-year economic expansion. Beyond increasing contribution rates, few options exist to bridge this gap beyond improving investment performance. Even investors with fully funded plans are focused on producing alpha in order to keep pace with growing liabilities.

As we have seen, investors have shifted assets to passive strategies, essentially forgoing an opportunity to outperform a benchmark and generate alpha. It's a powerful commentary that even these advocates of passive investing admit that ceding alpha potential from a portfolio may be perilous, especially for underfunded pension plans.

One way we see focused strategies becoming more relevant is through consultant screening activity. Specifically, "number of holdings," per the eVestment Advantage database, now ranks among the top criteria used by consultants when screening for large cap strategies. Furthermore, across all U.S. equity categories, 50 or fewer holdings is the most common parameter used among the consultants in the study. The majority of institutional investors and intermediaries Greenwich Associates polled believe the ideal number of securities in focused strategies is 50 or fewer.

In the eyes of investors, however, not all focused strategies with 50 securities or fewer are equal. The most important criterion when selecting a focused strategy is a manager's potential to generate alpha and so many investors connect alpha potential with active share. Investors who want an active manager to do more than "hug the benchmark" seek out focused strategies with high active share. Data shows that portfolios holding 26-50 securities deliver more active share in the large growth, large value, small growth and small value categories than portfolios containing 51 or more securities.

The investment consultants with whom Greenwich Associates spoke weighed in on other factors investors should take into account when considering a focused strategy. Their most salient piece of advice is understand positions a manager is taking and how those positions will correlate and interact with the holdings in the remainder of the portfolio. Through this portfolio-wide risk management function, investors may achieve the risk reduction benefits of diversification across strategies while preserving the focused manager's alpha-producing ability. In fact, one investment consultant claims that in a perfect world, 100% of his clients' active equity portfolios would be invested in focused strategies.

As you can see, the institutional investors and intermediaries are not alone in their enthusiasm for focused strategies. But what about risk in focused strategies? We've touched on risk a bit but there is more to glean from the study: in addition to the investment consultants, 84% of institutional investors expect that a portfolio of just 50 stocks can realize the primary risk-reduction benefits associated with a diversified portfolio. Among intermediaries, that share reaches 95%. Moreover, using beta and down market capture as proxies for risk, data indicates that focused strategies have typically delivered lower risk compared to larger portfolios across many domestic equity asset classes. One investment consultant notes that numerous focused managers have exhibited much lower risk than a benchmark or other peer group strategies.

When it comes to the future prospects for focused equity strategies, Greenwich Associates expects to see continuing and growing demand for those strategies run by skilled and experienced portfolio managers. We at Alger share this sentiment and suggest that you examine your equity asset allocation model and the returns you've earned. Do they meet your clients' needs? If your allocation to focused strategies is too low or your returns have been inadequate, share this study with your clients to spark a conversation about the many professionals using focused strategies to access alpha potential.

At Alger, focused strategies are a core competency of ours and we have seasoned experts who employ in-depth fundamental research to invest in our very best ideas. Our focused portfolio managers average 23 years of investment experience. As you strive to improve your clients' investment outcomes, we stand ready to partner with you. Our representatives are eager to help your clients gain the focused advantage. We encourage you to contact your local Alger representative to explore this potential opportunity.

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