Long-Only Equity Portfolio Construction with Concentrated Components

An Alternative to Conventional Multi-Management

December 2015

INTRODUCTION

The investment advisory business has undergone significant evolution over the past ten years as investors have endured significant market volatility, a financial crisis, and finally an equity market rally under the auspices of significant governmental intervention and abnormally low interest rates. With the proliferation of inexpensive passive equity investments, active investing has been taken to task as many managers have failed to generate any excess returns over their passive benchmarks for multiple years. As a whole, and partially in response to disastrous outcomes during the 2008 Financial Crisis, the amount of risk being taken by the average long-only manager has decreased, which, in the absence of an unlikely rise in the level of skill, leaves the active industry less likely to generate the necessary active returns to justify their risk or higher fees.

"Open architecture" makes hundreds, even thousands, of long-only equity managers available for inclusion in innumerable combinations. Yet we see significant shortcomings in manager selection and portfolio construction that leaves the end-investor still under-served. The current portfolio selection process continues to focus on combining multiple portfolios based on style, market capitalization, domicile, and/or process. While many of these portfolios include manager's best ideas, we believe it is also likely that other names in their portfolios likely have been included for risk diversification and control purposes. The result of "over-diversification", both within each managers portfolio and in the combination of multiple manager portfolios, is often market-like returns and risk with active fees. The challenge remains as to how to exploit the best ideas of multiple managers without diluting or over-diversifying the end result for the betterment of the end-client.

Belridge Capital was founded in 2009 with the goal of becoming an innovative provider of active asset management and advisory services. Our experience is deep in long-only active equity investing, both investment due-diligence and portfolio construction. We believe the best managers exploit their best ideas through concentrated investing. Our value proposition lies in selecting concentrated holdings by sector from managers with proven skill in the sector, and combining them in a portfolio construct that focuses the risk on stock-selection with sufficient, but not excessive, diversification, giving the end-investor the best chance for outperformance.

OUR METHODOLOGY:
Identifying Active Components

We follow three prime directives in order to best align our decisions with our clients' best interests. First, we evaluate entire portfolios of investment managers but we eventually select pockets of persistent skill to comprise a component of our final portfolio. These components will be equity holdings within a specific sector. Second, we look for high concentration within a specific sector that we believe will represent the portfolio manager's highest conviction. Third, our selection process for portfolio components occurs without regard to style or market capitalization which we believe may inhibit performance. Our final portfolio will consist of such components, combined in a manner corresponding to the ten GICS[1] sectors. The Belridge Capital Domestic Portfolio is benchmarked against the Russell 3000 Index and the Belridge Capital International Portfolio is benchmarked against the MSCI ACWI (All Country World) ex-US Index.

[1] MSCI/S&P Global Industry Classification Standard

Finding Conviction and Skill

Our manager selection criteria evolve around three themes:

1. A consistent and proven investment process based on bottom-up equity fundamentals
2. Demonstrated investment skill, especially stock selection, within one or more sectors of the market
3. Propensity to act on high conviction

Many investment processes are documented but do they follow it? A manager's investment process need not be overly sophisticated or complex (we would argue the opposite), but it must be explainable and consistent. The basic question: "Are you investing the way you say you will invest?" We favor those portfolio managers who are capable of listening and debating best ideas with analysts but take responsibility for all portfolio positions. In analysts, we are looking for subject matter experts who identify their best ideas and are able to make their case for their inclusion in the portfolio. Is there a documented sell-discipline and are there examples of it being followed? How does the manager deal with adversity if the style is out of favor or exogenous factors disproportionately affect results? We examine investment policy statements and interview portfolio managers, analysts, and chief investment officers independently to corroborate the investment process and ensure that it is supported at all levels of management.

Our second selection criterion is demonstrated persistent stock-picking skill. We believe skill is best ascertained at the sector rather than the aggregate portfolio level. Manager stock-picking prowess can be washed out at the aggregate level but more consistent in particular sectors of the portfolio. We parse portfolio holdings by sector over multiple tenors and ascertain the drivers of risk and return. We are looking for consistent, robust returns rather than "blow-out" quarters or single years that may skew long term performance. We will use both factor and "Brinson" (sector/allocation/interaction) methods to quantify and isolate idiosyncratic (stock-specific) return. It is important to understand the factor loadings often endemic or persistent for a specific portfolio manager's investment style. The Brinson method can help us ascertain stock-selection performance attribution, but since our final portfolio will be sector-neutral, attribution due to market timing (success with sector rotation as shown in the allocation effect) will not be relevant. Incidentally, we tend to favor portfolio managers who demonstrate their commitment to long term investing by tending to trade less often.

Factor performance attribution helps us understand the drivers of success beyond "selection" and "allocation." We utilize a risk model to disaggregate current portfolio *exposure* into various buckets of risk "factors." The model is also used to help evaluate portfolio *performance attribution* in terms of risk factors. This is particularly useful in understanding the "common factors," or characteristics that are endemic to groups of stocks; such as size, growth/value bias, or volatility. We pull our sector components "unconstrained" by design, but we are mindful of the factor biases that can be inherited in the final portfolio to ensure that we do not have unintended or excessive exposure to any single common factor. We control for this at inception, as well as through time in our rebalancing process.

Finally, our selection criterion is high conviction where best ideas are typically expressed with larger positions, however there are some caveats. Since portfolio position sizes may be a function of underlying index weights as well as conviction, we

consider both absolute and index-relative position sizes to uncover best ideas. A simple example of this would be a persistent 500 basis point position in Apple Inc. (AAPL), which appears large but is actually an underweight position size in recent years in many large capitalization benchmarks. The number of names within a given sector must be relatively low: we look for roughly 5-20 holdings. Sector active share will correspondingly be high[2]. We acknowledge that incentives endemic to the money management business--risk aversion and/or job preservation to name two--often dissuade equity managers from excessive concentration. Best ideas might be surrounded with other positions to diversify their risk and not necessarily generate alpha. Recent years have spawned an increasing higher percentage of closet indexing which we know is bound to fail, as the investor has not taken on enough risk in order to justify active fees. As an example, over the past 10 years, the average information ratio (active return relative to its active risk) for the top 10% of US Equity mutual funds is roughly 0.36. In order to generate 1% of active return while achieving this information ratio (IR), a given fund must have active risk (tracking error) of 1%/0.36=2.79%[3]. Roughly 36% of mutual funds today (representing roughly half of all mutual fund assets) are taking less than 2.79% of ex ante active risk. It is this phenomenon that convinces us that plan or platform sponsors using any combination of complete (and presumably diversified) portfolios, often comprising hundreds or more names, is sub-optimal resulting in market-like returns with active fees.

Other Due Diligence Considerations

Our selection process is purposely style agnostic. Ratings and index companies such as Morningstar, MSCI, FTSE/Russell, or Standard & Poor's, use their own methodologies for determining particular style categorizations. Some are more proprietary than others, but all are arbitrary in some way. Traditional asset manager "screens" rank managers according to their prowess within a pre-defined category (i.e. Small/Large/Value/Growth), which carries its own set of issues which are difficult to avoid, given the prominence of peer group rankings and the rewards associated with favorable standing. However, the bias is market-dependent: rewarding style "pure" managers/punishing managers investing outside their assigned style or vice versa. For example, if large value stocks are a weak performer in a given three year period, large capitalization value managers remaining pure to their assigned mandate tend to underperform those managers who have included smaller capitalization value or growth-oriented assets. This is no indication of stock-picking skill per se as the opposite scenario can and does occur. Investment managers have significant incentives to win the peer-ranking contests due to the perceived flow implications. Ratings agencies do not want to reclassify investment funds too often for obvious reasons, thus mistakes may occur on both sides. Investment managers can and do game the system (by category or by fund investments) in order to achieve strong rankings. Moreover, investments in supposedly different styles can be stubbornly correlated at the wrong time.

The level of Fund assets are another important consideration as it relates to success as well as scalability and capacity. Asset growth, obviously often the goal, occurs by success and/or subsequent inflows. However it happens, a larger portfolio typically increases the number of holdings as large positions become more difficult to own based on liquidity and capacity constraints—perceived or otherwise. Fund families may have built-in liquidity and/or capacity "circuit-breakers" in place which prevent

2 "Active share," a term coined by Cremers & Petajisto, refers to the portion of the portfolio (expressed as a percentage) that differs from its underlying benchmark. See Martin Cremers & Antti Petajisto, "How Active is Your Fund Manager? A New Measure That Predicts Performance," Working Paper, Yale School of Management, 2009.
3 "Tracking Error" (a.k.a. "active risk,") is the conventional measure of "volatility" or the return dispersion between the portfolio and the benchmark. It is computed by calculating the standard deviation of the return differences and usually expressed as an annualized percent. Tracking error can be calculated in arrears (ex post) or on a predicted (ex ante) basis using a risk model.

them from owning more than a certain percentage of a company's investable shares. This is all reasonable but even as investment success continues, the end investor likely holds a less concentrated portfolio containing less "best ideas" as a percentage of overall assets and correspondingly more "ballast" positions to control risk and provide liquidity. The manager may be forced to alter a successful investment style instrumental in garnering those assets, i.e. move "up-cap" or own larger (more liquid) names. This phenomenon is typically most pronounced with small cap managers, where asset under management of $1bn or more often present challenges not seen at lower asset levels or mid-cap managers whose most successful names might grow out of a specified investment capitalization guideline.

Portfolio Construction Process / Combining Active Sector Components

While we have not selected our portfolio components with regard to risk at the sector level, risk is paramount at the portfolio level. We will control for excessive name or style overlap as well as factor exposure. Each selected sector component will be added at the overall index weight. Sector/industry risk is a large component of typical tracking error. By combining our GICs sector components at index weight; we seek to minimize sector risk, leaving idiosyncratic (stock-specific) risk to be the largest portion of the portfolio risk budget. Despite each sector portfolio being sufficiently "risky" in its own right, the final combination will be far less due to this portfolio construction process. Figure 1 below shows the predicted tracking error (ex ante active risk) of the sector components using a factor model. The final portfolio active risk is also shown.

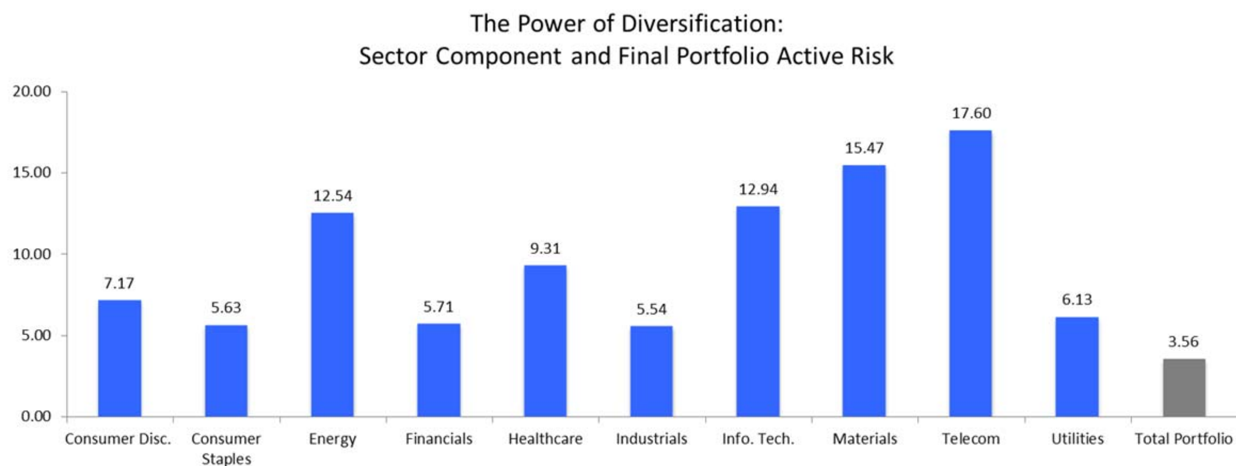

Figure 1 (Source: AlphaBetaWorks - Insights)

The predicted tracking risk for components in the chart above is computed against the iShares Russell 3000 ETF (IWV) sectors. The higher level of risk for the various sectors relative to the final portfolio means that we have significantly diversified the total relative risk, which we have optimized with no sector tilts. Figure 2 below shows the sector component tracking error plotted against their active share, as well as the final portfolio.

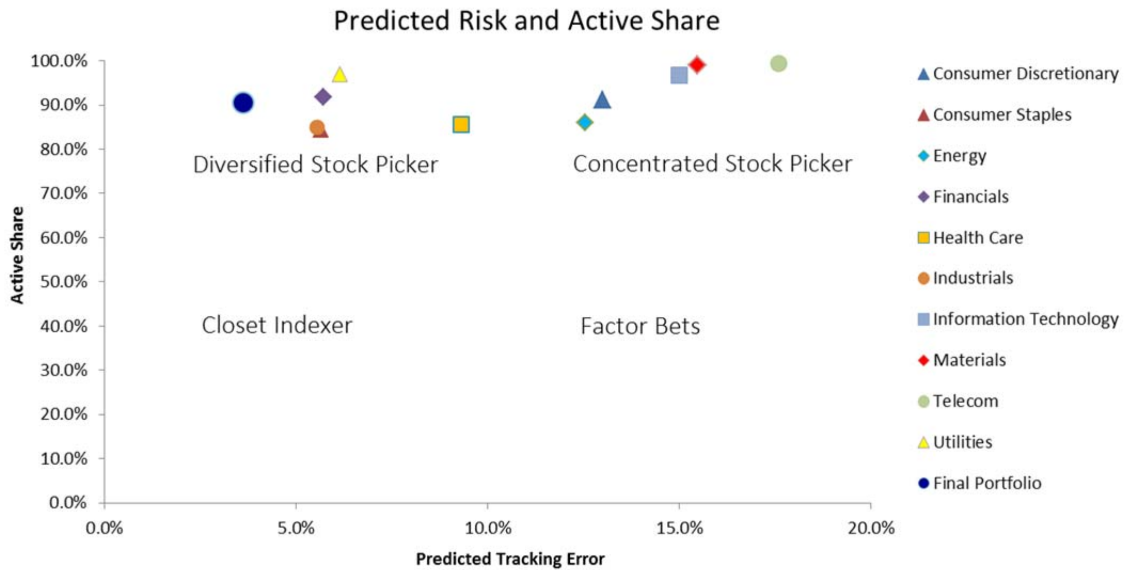

Figure 2 (Source: AlphaBetaWorks - Insights)

CONCLUSION

Belridge Capital is offering a better way to harness the available alpha in the equity market, which we know will always exist. In our view, many investment strategies utilized in client solutions apply an investment manager's skill too broadly. Stock pickers are hindered by portfolio management decisions that limit their abilities to create alpha. The business has created this phenomenon as fund families clamor for high peer group ratings and managers themselves are being pushed towards less risky overall portfolios. At the plan or platform level multiple complete active investment strategies, are combined together which further dilutes the end solution—the client's portfolio--and leads to over-diversification. This results in market-like (passive) performance with active management fees.

Belridge Capital's due diligence and portfolio construction process is designed to surmount many of the industry challenges while utilizing well-documented academic principles of concentrated investing:

- Conduct due diligence to identify superior manager investment processes and skill within specific sectors;
- Combine high performing manager components with robust returns and high concentration at sector neutral weights, providing proper diversification to maximize stock-specific risk within the risk budget;
- Rebalance the portfolio, relatively infrequently, in a slightly different manner than common practices of the industry, controlling for factor loadings.

Unlike typical multi-management constructs, comprising hundreds of names, our final portfolios are compact—typically less than seventy-five positions—with high active share, and provide full market exposure. Our portfolios fit well within a core/satellite construct as a risk-controlled "alpha-producing" core solution, which differentiates us from passive core portfolios. Client needs and expectations will continue to drive product evolution and we believe Belridge Capital's solution to channeling manager skill is a step in the right direction.

ABOUT THE AUTHOR

Daniel B. Wanzenberg, Chief Executive Officer and Chief Investment Officer

With twenty years of asset management experience, Mr. Wanzenberg founded Wanzenberg Partners, LLC in 2009, which was formed into Belridge Capital, LLC in 2014, where he now serves as the Chief Executive Officer and Chief Investment Officer. He has held a variety of senior level positions in the financial services industry. Mr. Wanzenberg launched and managed ABN AMRO's North American global multi-manager program. At ABN AMRO, Mr. Wanzenberg was responsible for all aspects of the program, including manager due diligence and oversight, client asset allocation, sales and marketing, key client servicing, and operations. Prior, Mr. Wanzenberg held positions at Envestnet, responsible for building their investment manager platform, and Nuveen Investments as a performance analyst.

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