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Rethinking portfolio construction

3 HABITS OF HIGHLY EFFECTIVE 'ACTIVE' INVESTORS

iShares by BlackRock

Capital at risk. The value of investments and the income from them can fall as well as rise and are not guaranteed. The investor may not get back the amount originally invested.

750+

BlackRock Portfolio Analysis and Solutions (BPAS)[1] have helped **over 750 European institutions**[2] in **assessing and repositioning existing portfolios,** and in building new propositions.

Through these consultations, discretionary wealth managers, pension funds, insurers and fund-of-fund managers alike are questioning existing investment processes, fueled both by regulatory catalysts and the desire to stay competitive amidst a rapidly changing macro environment.

> **"Building a successful multi-asset portfolio, today more than ever, requires us to re-assess past investment habits. New norms are being established and known structural trends are accelerating, meaning a rethink is required for the future success of portfolios."**
> Ursula Marchioni, Head of BPAS EMEA, BlackRock

We believe a complex and rapidly changing world demands a new approach to portfolio construction. We reflect on three habits that are shared by some of our most effective 'active' investors.

1
ACTIVELY UNDERSTAND THE PORTFOLIO

2
ACTIVELY IDENTIFY AND COMBINE DIFFERENT SOURCES OF RETURN

3
ACTIVELY USE THE WHOLE INVESTMENT TOOLBOX

1 BPAS (BlackRock Portfolio Analysis and Solutions) is a team of portfolio consultants which seeks to provide industry leading tools, analysis and insights for our clients. Through customised, outcome-orientated client engagements around portfolio construction and risk management, the team can assist clients with asset allocation, portfolio restructuring and implementation decisions. **2** BlackRock Portfolio Analysis and Solutions, from January 2018 to May 2020.

1 ACTIVELY UNDERSTAND THE PORTFOLIO

Know what you hold

Historically, portfolio builders have placed a strong emphasis on fund selection, whereby the ability to shortlist the best managers has been the unique value proposition and differentiator amongst competitors.

While important, fund selection can only be relevant as part of a rigorous portfolio construction process that starts with a clear understanding of the underlying risks and performance drivers. This has led to an increased focus on risk management systems by investors across all segments.

> **“The need to refine portfolio construction and take a ‘whole portfolio view’ is a common thread across the findings, whether it is to ensure a better understanding of underlying return drivers and correlations or to drive more efficient use of limited risk budgets.”[3]**

The best funds don’t always make the best portfolios

It is increasingly apparent that several product-focused practices favoured by portfolio builders for many years introduce a number of inefficiencies into a portfolio. Rather than a holistic approach which retains a focus on the investment objective and its key drivers, a siloed approach is based on separate asset allocation and product decisions which are then retro-fitted together.

As an example, when building portfolios, underlying alpha-seeking managers are often selected because of their belief that they can outperform the respective benchmark. Single fund performance will be important, but the value generated by outstanding single funds can be easily destroyed if these are combined inadequately within a portfolio and do not work cohesively toward the investment goal.

Drivers of these results are **cancelled** (or, at the opposite end, **compounded**) active bets among managers. If a portfolio combines managers expressing opposite views, their respective expertise could end up being eroded. When many managers are selected within the same exposure, the portfolio could end up over-diversified with the piling of strategies resulting in an outcome potentially very close to that of a broad market index – but at the price of an active investment.

Source: BlackRock, as at June 2020. For illustrative purposes only.

3 Source: BlackRock, Global Insurance Report 2019.

Dig deeper, think broader

Successful investors are those able to control and monitor their portfolios holistically. This means that their choices of managers and products are always assessed not just as standalone decisions, but in the context of the portfolio as a whole. It is not just about the strategy's ability to deliver alpha, it is also about how the combination of the chosen strategies might fit versus the original asset allocation. The **ability to control unintended deviations** from the target portfolio due to sub-optimal combinations of products is key when working towards successful outcomes.

Multi-asset risk management and portfolio construction technology are vital in assisting investors through this process. Looking under the bonnet, at the underlying exposures and portfolio risk/return drivers, can give investors the tools to keep more control of their portfolios and deliver successful results.

2 ACTIVELY IDENTIFY AND COMBINE DIFFERENT SOURCES OF RETURN

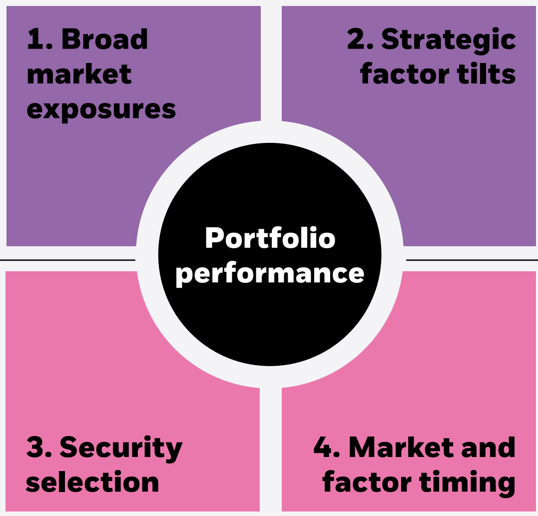
Select returns deliberately

We identify **four components** which determine the outcome of a portfolio.[4]

Portfolio core performance

An investor's strategic asset allocation decisions, or the broad market exposures, and the relative weights the investor wishes to maintain for the long term.

Macro and style factor tilts the investor wishes to embed in the portfolio for the long-term, believing these rewarded drivers of return can help achieve the desired outcome. Popular examples include momentum, quality and size in the equity space and real rates, inflation and duration in fixed income.



Expression of granular views at single stock or bond level — driven by insights which are not reflective of the broader market positioning. Over- and under-weights of a single security vs its weight in a benchmark is an example of this.

Dynamic choices aimed at capturing shorter-term opportunities in asset classes or factors. Opportunistic over- and under-weights of asset classes, countries, industries or factors are primary examples.

Additional sources of return

Source: BlackRock, as at June 2020. For illustrative purposes only.

4 For additional academic research on this taxonomy, refer to: Andrew Ang, Michael W. Brandt, David F. Denison [2014]. Review of the Active Management of the Norwegian Government Pension Fund Global.

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90%

These drivers are not all equal. Often above **90%** of portfolio outcomes are linked to **broad market exposures** and **strategic factor choices**.[5]

As an example, when looking at European equity long-only managers, 75% of alpha-seeking managers could explain 90% of their returns through the performance of the MSCI Europe Index. For all managers, the market had an explanatory power greater than 70%.[6]

This is a not a new concept, and an extensive body of academic literature well-known to investors has been published on the topic since the 1980s. Yet, successful investors are those that have not only accepted these concepts, but have also acted to align their day-to-day portfolio construction processes to them.

Knowing that the bulk of portfolio outcomes is largely determined by the first two drivers described, successful investors have reallocated resources to focus on designing the right strategic asset allocation that balances risk with the required return. Product implementation is then executed under strict monitoring of how the overall portfolio compares and contrasts which such theoretical asset allocation.

Active works with passive

The role of manager selectors has moved beyond selecting outperforming managers and is progressively prioritising identifying the sources of return that they want to capture and how these can be efficiently accessed through blending of index, factor and alpha seeking strategies.

Going beyond the false dichotomy of 'active' and passive' investing, successful investors have often recognised the value of expressing their long-term market and factor choices through index vehicles and deploying their fee budget to acquire alpha excellence from managers skilled in timing exposures and factors, and in selecting securities.

> **“The freeing up of the fee budget made possible through increased indexing is especially important as institutional investors have been increasing their allocation to private market funds, which generally have higher expense ratios, in search for yield and sources of diversification.”[7]**

Through a greater recognition that all investment decisions are active, successful portfolio builders have been able to focus on delivering outcomes with greater efficiency and evolve their unique value proposition beyond manager selection.

5 Gary P. Brinson, L. Randolph Hood, and Gilbert L. Beebower [1995]. Determinant of Portfolio Performance. **6** Source: BlackRock, Morningstar as at June 2020. Performance assessed based on 5 year returns from 01/05/2015 - 30/04/2020. Analysis on 180 alpha-seeking managers that are benchmarked to the MSCI Europe Index, had a 5 year track record and fell within the Morningstar Category 'Europe Large Cap Blend Equity'. Explanatory power measured by looking at the style R2 versus benchmark. **7** Source: BlackRock, 2020 Global Institutional Rebalancing.

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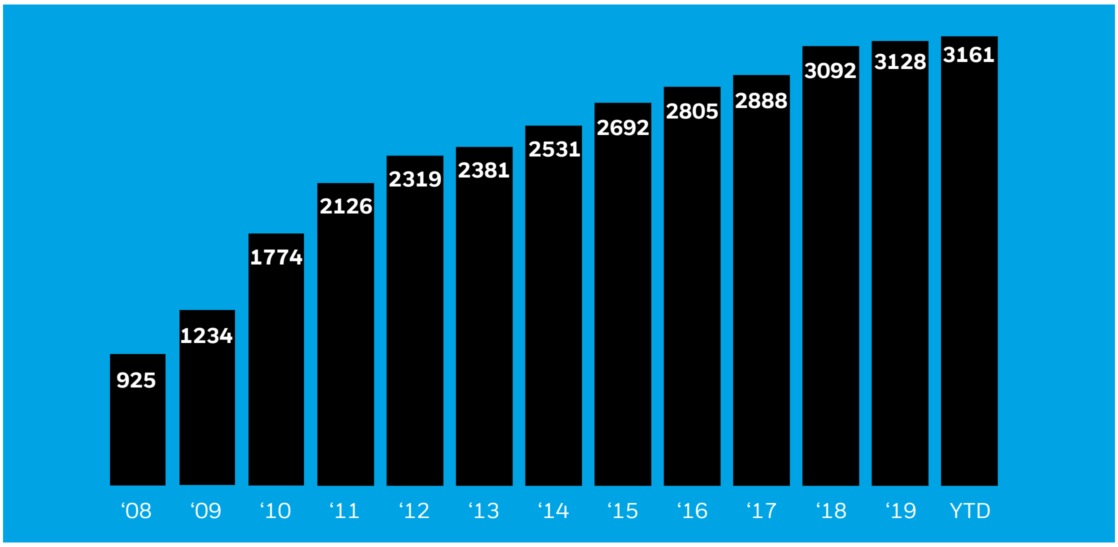
3 ACTIVELY USE THE WHOLE INVESTMENT TOOLBOX

Pick the right tools

The investment toolbox available to investors has expanded enormously in recent decades, and continues to do so. The growth in index instruments, as well as an increasing growth in alternatives allowing access to illiquidity premia, are two of the standout trends.

To give a perspective on the index industry: in Europe, we counted over 3,100 Exchange Traded Funds (ETFs) available to investors at the end of May 2020 compared with 850 available at the end of December 2008.[8] In addition, major index providers offer nearly 3.2 million indices globally.[9] These figures provide an indication of the breadth of solutions and precision of exposure delivered by ETFs and index mutual funds.

ETFs available to investors



Source: BlackRock Global Business Intelligence, as at May 2020. Number reflects the ETFs based on all primary listings in Europe. Share class launches are not included.

8 BlackRock ETP Landscape. End May 2020. Fund count does not include share classes, which are counted as one fund. **9** Index Industry Association; survey of 14 member firms conducted June, 2018. Available at: https://www.etfstrategy.com/iia-survey-reveals-3-7-million-indices-globally-39494/.

Index for alpha

As availability of data and technology evolve, systematic returns can increasingly be accessed in cost efficient manners through indexing.

Factor-based strategies are a great example. Up to a decade ago, one of the few ways end investors could gain exposure to persistent drivers of return such as value, momentum or quality was through alpha-seeking managers. Now, factors have become available through a significantly larger range of strategies, including ETFs.

> **"We will use Smart Beta where we can to bring down costs but still have the ability to express view about a market."** UK Wealth Manager[10]

Alpha capabilities are therefore progressively re-focusing on delivering idiosyncratic returns which cannot be replicated other than through manager skill — such as market and factor timing, or security selection.

This is changing active investors' behaviours and leading to a transformation of the alpha space which ultimately will benefit all investors.

Successful investors are those that have been able to efficiently deploy their fee budgets, replacing alpha-seeking funds which have delivered benchmark-like returns with indexing vehicles. This frees up fee budget to purchase alpha-seeking managers which will provide truly unique, idiosyncratic sources of risk and return.

Strike a balance

Alpha management remains important, but finding the right balance is too. Consolidating the number of alpha-seeking managers leads to improved fee budget allocation, as the ability to deviate from the benchmark is deployed to alpha-seeking managers whose selection skills make a difference.

Overall, we believe that leveraging technology to consciously and effectively combine different vehicles has profound effects on the portfolio built and the outcomes that are delivered. We believe that this will progressively represent a bigger component of distributors' success in the years to come.

> **"We're just not going to pay active fees any more unless the manager can deliver consistent alpha. We like active management – it's not 'dead' – but we simply will not pay 70, 80, 100bps for a manager to stick to his benchmark just because he needs to stick to his mandate."** Continental Europe Wealth Manager[10]

Further reading: Active Portfolios Start with Indexing.

Want to know more? iShares.com

10 BlackRock, *2019 Wealth Industry Evolution* survey. Based on interviews of 15 large European distributors across different jurisdictions.

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