Rethinking portfolio construction

ACTIVE PORTFOLIOS START WITH INDEXING

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. Investors may not get back the amount originally invested.

Through BlackRock Portfolio Analysis and Solutions' (BPAS) interactions with clients over the last few years, successful investors stand out because of their:

- Higher adoption of illiquid and 'real' alpha-seeking strategies
- Higher index adoption
- Deliberate and adaptable approach to blending these solutions

In line with this, we have seen an ongoing shift to index strategies amongst investors, with both distributors and end investors changing their perception of the role and value of index vehicles. We reflect on why indexing matters.

SAVE TIME	MANAGE RISK	CURB COSTS

SAVE TIME WITH INDEXING

It takes time, skill and effort to determine which managers deliver 'true' alpha (returns which are non-systematic and cannot be captured via index solutions) and to continually monitor and review these managers' performance.

As the number of products available to investors increases, the cost compounds. There are currently **over 49,000 funds** domiciled in **Europe**,[1] nearly twice the number of instruments available a decade ago. The size of these funds (assets under management, AUM) varies greatly, suggesting diverse investor choices and a lack of consistently performing managers.

The complexity of selecting bonds has increased over the years as well. About 840,000 bonds have been issued[2] between 1 Jan 2015 and 31 Dec 2019. The number of constituents in the Bloomberg Barclays Multiverse Index, a popular index which covers both investment grade and high yield bonds globally, has increased from about 20,000 in 1 Jan 2015 to about 28,000 in 31 Dec 2019.[3] The process of selecting bonds has become more complex, especially when liquidity is taken into account.

1 Morningstar, as at April 2020. The number includes all alpha-seeking, index mutual funds and ETFs domiciled in Europe. This number excludes share classes. **2** Source: Bloomberg as at 7 April 2020. Includes corporate and government bonds. **3** Source: Bloomberg as at 7 April 2020.

What does this mean for investors?

The BlackRock Investment Institute (BII) conducted a study of 4,500 alpha-seeking managers across 21 asset classes to assess performance persistency, of managers that remained in the top quartile over 5-year periods.[4] A **meaningful persistency probability would be above 25%.** Interestingly, this was found to be the case for only a few asset classes based on the set of confidence bands. In all other instances, the 'good' selection of a successful manager could not be set apart from a random choice.

Research from Morningstar[5] highlights the inverse relationship between time horizon and the ability of top-performing funds to maintain their position, showcasing that relatively few funds can consistently stay at the top over the long-term. The Morningstar analysis highlights that 32% of active global large-cap equity funds outperform the index equivalent over one year, decreasing to only 15% of funds over three years, and 10% over five years.

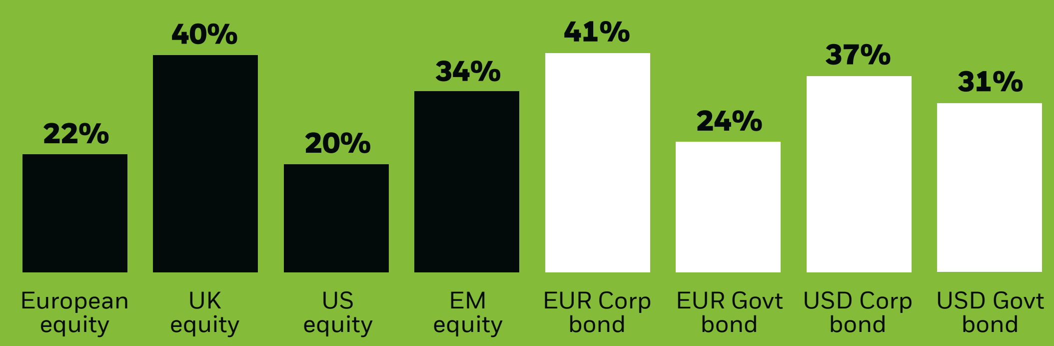
For active global bond funds, 21% outperformed the index over one year, decreasing to 19% over three years and 11% over five years.

Indexing for returns

In other words, **building portfolios with consistently top performing managers involves turnover.** This constant search, selection, performance assessment and reselection are a **cost that should be taken into consideration.**

Investors who do not have the capacity to research and regularly monitor their managers may be better off by consolidating the number of alpha-seeking managers in their portfolio and considering greater index selection. These choices will help to make portfolio and risk monitoring more efficient while minimising implementation, transaction and governance costs and focusing selection skills on the areas of true expertise.

% of managers that remained in top quartile from 2015 – 2019



Past performance is not a reliable indicator of current or future results and should not be the sole factor of consideration when selecting a product or strategy. Source: Morningstar Direct, as at of 12/09/2019.
Data measured between 30/06/2015 and 30/06/2019.
For illustrative purposes only.

4 BlackRock Investment Institute, "Blending alpha-seeking, actor and indexing strategies: a new framework", July 2018. Analysis conducted based on last 20 years from 1997 to 2017. **5** Morningstar, as at 31 March 2020.

MANAGE RISK WITH INDEXING

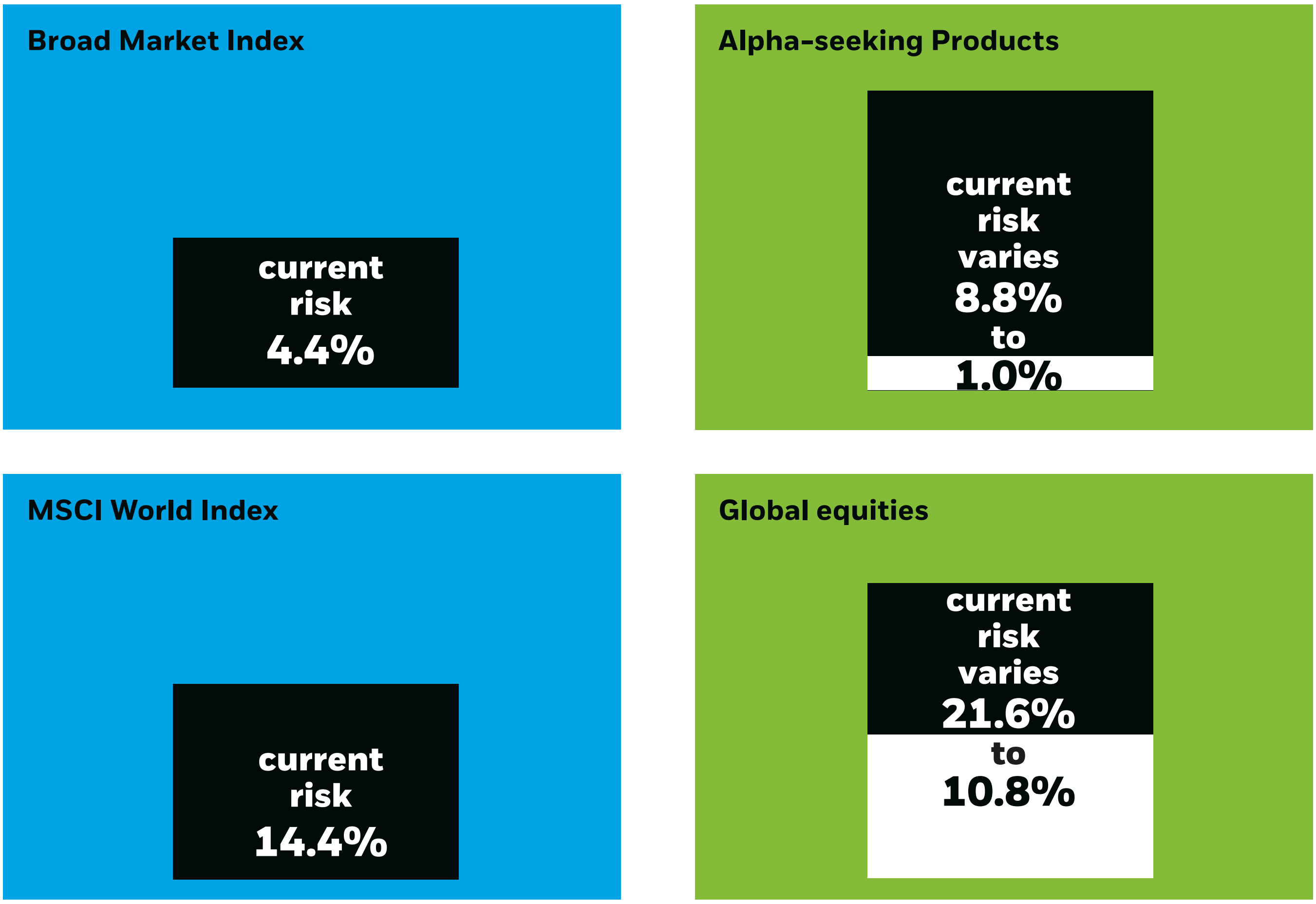
One of the key components of successful portfolio construction is understanding the risks of the investors' investments. Unlike returns, risks can be more easily predicted and controlled.

Understanding risk goes beyond looking at products in a siloed approach and requires investors to assess, monitor and manage risks at whole portfolio level.

Typically, portfolio construction starts by designing a strategic asset allocation at an index level and is then implemented through a variety of instrument choices, with the product choices structurally separated from asset allocation decisions. This assumes that by fitting products into an asset allocation, the risk of the portfolio will be aligned with that of the theoretical combination of indices the allocation has been designed with. But when moving from theory to reality, two implementations of the exact same asset allocations can have very different risk profiles.

For example, looking at European corporate bond managers, an equivalent broad market index would currently have a risk of 4.4% in EUR terms. And yet, implementation with alpha-seeking products — or a blend of index and alpha — could lead to a risk from 1.0% to 8.8%, depending on the manager chosen. In many instances, we find that managers with more flexible mandates will allocate into other exposures, outside of investment grade credit, in order to achieve their investment objectives, but potentially having significant impacts on the total risk.

Risk: While the investment approach described herein seeks to control risk, risk cannot be eliminated.



Analysis based on all European domiciled active managers with a 5 year track record, and within the Morningstar Category 'EUR Corporate Bond' and a similar dispersion was found when assessing Global Equities. Source: BlackRock, Morningstar from 30/04/2015 - 30/04/2020. Analysis is base currency i.e. EUR for EUR Corporate Bond and USD for Global Equities. Data frequency = monthly.

How technology can help

The BlackRock Portfolio Analysis and Solutions (BPAS) team[6] leverage the power of BlackRock's risk management platform to help clients understand and manage risk exposures within their portfolios. Through these interactions, we identify that there is often a misalignment between the investment outcomes that clients have stated and the actual exposures of their portfolios. This can be caused by:

Manager style drift	In this case, the evolution of choices made by alpha-seeking managers overtime. Investors select managers for specific purposes, for example to gain access to an asset class. Within their mandates, managers will be able to deliver on their objective in different ways, and these 'degrees of freedom' might lead to overall portfolio exposures which are different from the ones intended at theoretical asset allocation level. Think about sectors, country, currency or factor tilts which weren't necessarily the focus when selecting the specific manager.
Over diversification of managers	In this case, products have been chosen for a specific purpose, and successfully in terms of identifying good managers. Yet, many instruments are chosen within one asset class, leading to small allocations to each vehicle. As a result, the products selected for a specific purpose may contradict views expressed elsewhere, resulting in the combined portfolio resembling different views to those intended.
Bond and stock selection	In this case, investors opt to focus a portion of their portfolio on single bond or stock selection, in attempt to access idiosyncratic sources of return. Yet, if many bonds or stocks are chosen, leading to small allocations to each security, investors can often find that such source of return is eliminated. Risk management tools can help determine to what extent the risk profile of such investments is truly differentiated from that of an index.

Risk - While proprietary technology platforms may help manage risk, risk cannot be eliminated.

Indexing for control

When it comes to implementing an asset allocation view on a specific market or asset class, **indexing can help to control risk** and **reduce the misalignment** between the target and the investable portfolio. Furthermore, it allows investors to **free up risk and fee budgets** to express tactical views with conviction through successful alpha managers.

6 BlackRock Portfolio Analysis and Solutions (BPAS) 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.

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€ CURB COSTS WITH INDEXING

There is more pressure than ever to reduce portfolio costs, driven by transparency and increased scrutiny on fees. This is a transformation that is having profound impacts on portfolio allocations and shifting distributors' revenue models.

> **"Clients talk about value for money now, that's something that we didn't use to have conversations around, but it's just because costs are under the microscope across every part of the value chain. So clients squeeze us, we squeeze managers."**
>
> UK Wealth Manager[7]

Indexing for performance

When it comes to performance: costs matter. This is amplified in a low return environment.

Success goes beyond simply reducing headline management fees, since in many instances, accessing strategies at a premium is needed when building towards portfolio outcomes. The real question portfolio builders should ask themselves is: **could a similar portfolio outcome be achieved in a more cost-efficient manner?**

BlackRock believes that, unless a manager can consistently capture idiosyncratic returns which outweigh their management fee, an index vehicle may be a more cost-efficient way to access the given exposure.

Further reading: 3 Habits of Highly Effective 'Active' Investors

Want to know more? iShares.com

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

Risk warnings

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