BlackRock®

A guide to building an equity portfolio

Building an equity portfolio

When it comes to thinking about portfolio construction, investors should not assess these strategies in silos. To maximise the opportunities available in the equity space, the real question should be:

How should I best blend different types of equity investments to ensure my portfolio outcomes are met?

Index, factor, long-only active equity, hedge fund and private equity investments each offer a unique opportunity set that deserve a place in any equity portfolio. Thoughtfully combining them can lead to a better portfolio outcome.

Key considerations

When it comes to selecting across different investment styles and strategies, it is important to consider the following aspects:

1. **Overall portfolio objective**
2. **Cost/fee budget**
3. **Time and research capabilities**
4. **Accessibility of tools and technology**
5. **Knowledge of the market**

Overall portfolio objective

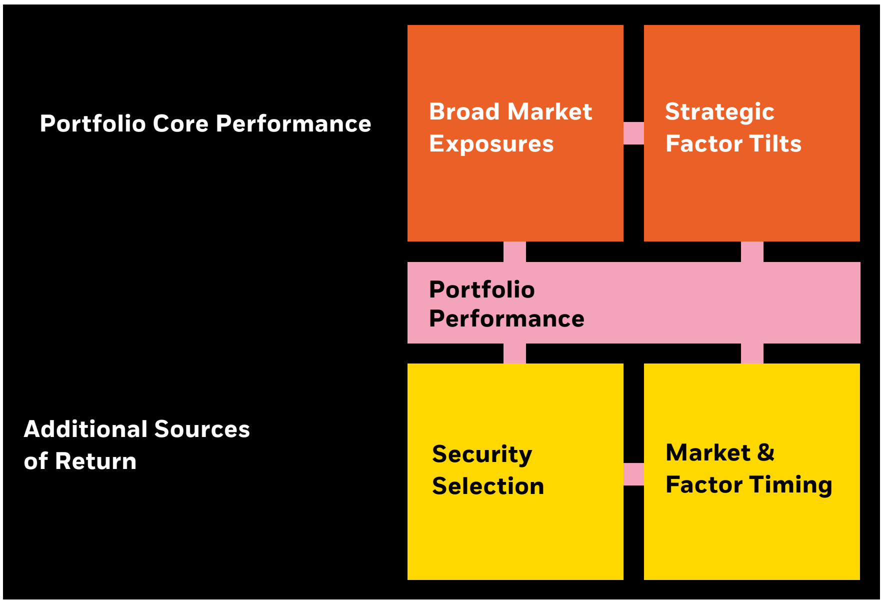
To meet long-term portfolio objectives, an investor needs to start by assessing the expected risk and return across different market exposures and their interaction between each other.

Being able to quantify a view across different financial markets is paramount to building portfolios designed for the current and future market environment. This starts by forecasting the future risk and return of an asset over different investment horizons. This is no easy feat as there is rarely consistency of opinions across industry experts.

At BlackRock, we understand the complications and limitations of predicting the future and incorporate uncertainty into our assumptions to reflect this. This process of considering multiple return pathways helps to build a more diversified and resilient portfolio over the long term – and allows investors to stay aligned with their overall portfolio objective.

Many investors have total return objectives, with the ultimate satisfaction measured by the overall amount of return received net of fees. This return can be broken down by four key drivers: i) asset allocation choices; ii) static factor tilts; iii) timing (i.e. rotating choices across exposures or factors) and iv) security selection.

Figure 13: Understanding the drivers of return



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

The spectrum of investment strategies enables investors to assess all of these in multiple fashions. However, understanding the return drivers in each investment style can help to inform the weighting required in order to meet this portfolio objective.

A straightforward approach may be simply to implement the desired asset allocation through index strategies. This will help to minimise costs and the need to take on additional excess risk versus the asset allocation. However, many investors look towards active strategies or private markets to outperform their forecasted market returns. Deciding the appropriate weighting between these investment styles, guided by risk and fee budgets as well as broad market return expectations, is crucial for long-term success.

There is no guarantee that a positive investment outcome will be achieved.

Fee budget

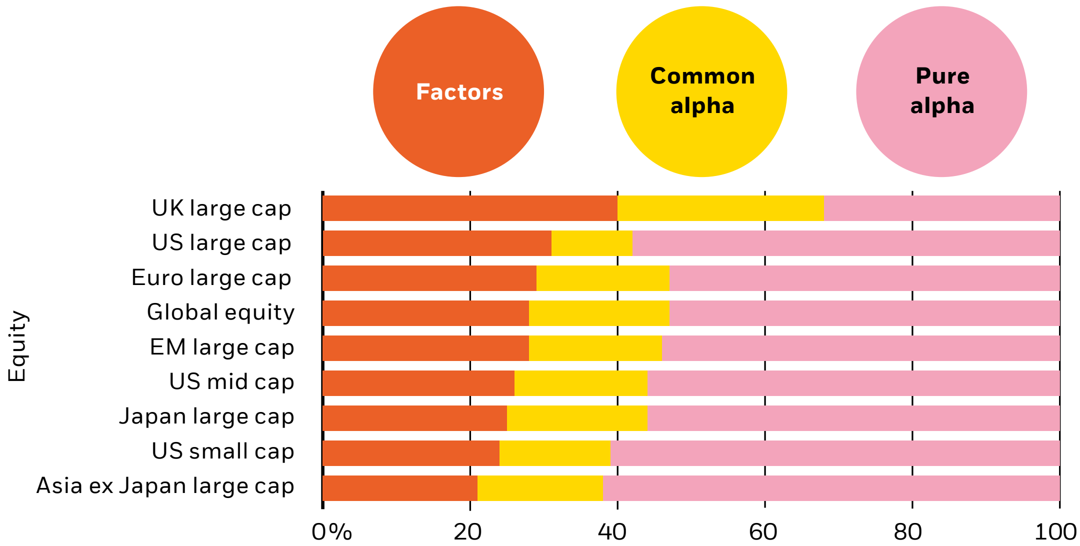
Another important consideration is an investor's fee budget, in other words how much an investor is willing to spend on sourcing differentiated returns.

To build a successful portfolio, an investor should consider having exposure to four of the key drivers of return referenced in Figure 13. Yet, the cost of accessing these drivers of return is not equal.

Hedge funds and private equity investments help an investor access idiosyncratic sources of return – through timing and security selection – however, these typically come at a higher cost. Investors can balance their overall portfolio costs by blending more cost-efficient vehicles alongside these. This balance has become ever more important with regulation putting greater focus on cost transparency.

When it comes to long-only active equity investments, at BlackRock, we evaluate manager performance by breaking down the excess return profile by attributing returns to that coming from factors, common alpha and pure alpha.

Figure 14: Percentage of excess return variance across exposures explained by different factors



The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.

Sources: BlackRock Investment Institute, with data from Morningstar, MSCI, Bloomberg Barclays, JPMorgan, FTSE, S&P, iBoxx and Thomson Reuters as at July 2018.

Notes: The chart is based upon research from the BlackRock Investment Institute on a sample of about 4,500 managers in the Morningstar database across nine equity exposures between 1997 and 2017. The chart demonstrates the degree of each of these components found across different equity asset classes. Whilst this should be treated as a guide, it can help to inform in which equity exposures, there is a greater percentage of pure alpha returns, and, therefore, where investors may want to focus their resources to allocate available fee budgets optimally. All returns throughout are in US dollars.

As shown in figure 14, in many cases, a meaningful amount of returns can be attributed to static exposures to factors. While this might have been considered 'alpha' in the past, the ever-expanding array of factor indices means that investors now have a much greater ability to efficiently tilt their portfolio towards these factors, without the need to employ an alpha-seeking manager.

The remaining portion can be divided into 'pure alpha' – which comes from timing or security selection – and 'common alpha' – the return related to factor exposures that, while systematic in nature, are harder to access and directly invest.

The cost of alpha-seeking strategies therefore needs to be compared to the alpha (both pure and common) that a strategy can provide, beyond static factor exposures. This will help to distinguish where investors should be willing to access strategies at a premium, and where investors may be able to find other opportunities to better manage the overall fee budget.

Time and research capabilities

Beyond the headline product fee, governance costs – namely the time required to find and oversee the 'right' manager – are also a key consideration.

Identifying valuable managers and the persistence of their performance over time are crucial to selection criteria. Sources of alpha are, by their very nature, unpredictable and ever-changing. This makes the selection of valuable managers both an art and a science.

To illustrate with a focus on active equity managers, we looked at the probability of managers staying in the top and bottom quartiles in subsequent five-year periods if they were in that quartile in the previous period.

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 other words, the selection of a successful manager could not be set apart from a random choice.

Research from S&P[4] similarly echoes 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.

Similar challenges are faced with both factor investing and private equity investing too.

- Single factor performance is prone to cyclicality, meaning that periods of underperformance versus the broad market index will be inevitable if factors are not tilted with relevance to the current market regime.
- And with private equity, we identify there to be an even greater dispersion than in public markets between the returns of different managers.

Assessing past performance paints only a partial picture. Selecting managers and building portfolios, which consistently outperform year-on-year, requires great manager selection and strong ongoing oversight. Investors need to balance the use of such products with the opportunity cost in relation to both the time and effort required.

The ongoing manager due diligence this requires on top of the implementation and transition costs incurred from potential higher portfolio turnover, are factors which should be taken into consideration as part of the investment making process.

For investors who have limited resources for these activities, consolidating the number of alpha-seeking managers within the portfolio and deploying greater usage of index products for the core of their portfolio can help to improve long-term outcomes.

There is no guarantee that a positive investment outcome will be achieved.

4 https://us.spindices.com/documents/spiva/persistence-scorecard-december-2019.pdf.

Accessibility of tools and technology

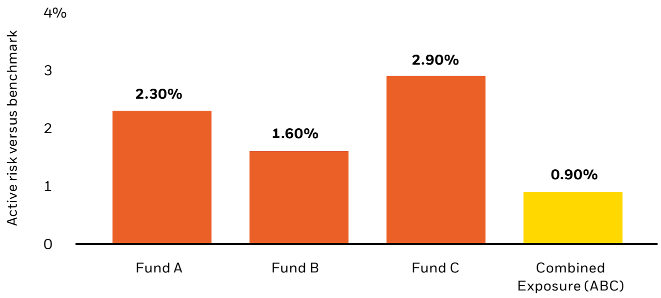
To be able to accurately assess portfolio alignment with portfolio objectives, investors need risk management tools and technology to gain a holistic view on the overall portfolio.

Simply buying the top performing managers does not lead to building the best portfolio. What is needed is the ability to be able to understand the underlying portfolio exposures and identify the clearly defined drivers of return.

Take the example below (Figure 15) of three long-only active equity managers, each operating with the same benchmark. Individually, these all have substantial levels of active risk versus the benchmark, demonstrating that alpha opportunities exist. However, when combined, the active risk is significantly lowered.

While idiosyncratic sources of return were visible at an individual manager level, the combination of strategies led the portfolio to be overdiversified. In other words, the factor, sector and country bets taken by one manager contradicted that of the other and any excess returns from 'pure alpha' that may have existed had been negated.

Figure 15: Ex-ante active risk of three active equity managers versus the benchmark



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

Blending across investment strategies requires visibility into underlying exposures and return drivers. The use of risk management tools can help ensure that manager decisions across the equity investment spectrum are complementary of each other and are all working together towards the defined investment goal. It can also help inform the weighting required across strategies.

Without access to such tools and technology, investors face the risk of taking unintended risks or deviations from their expected outcomes. Building indexed-only portfolios helps to minimise such a risk, but for increased-complexity portfolios – where investors seek enhanced returns through a mix of long-only active equity, hedge funds and private equity – the need for regular portfolio monitoring through risk management technology is significantly increased.

Knowledge of the market

Knowledge of the market will also be a key consideration to the investment process. Private equity is a prime example where the lack of data availability on early and growth stage companies can make it challenging to make informed investment decisions. Many investors will, therefore, rely on private equity managers, as opposed to identifying opportunities directly.

Hedge funds are another example, whereby analyst reports show a strong positive bias, with 'sell' ratings having been historically less observed than 'buy' ratings. Further, many companies' outlooks are designed to 'under promise and over deliver' in order to push stock prices higher. This means that data informing shorting opportunities are much more opaque and may be better left to specialist investment teams.

At the other end of the spectrum, when it comes to investing within home equity markets, many investors feel they have a good understanding and transparency around company and market events. This means investors may be less likely to outsource these decisions to a fund manager. Instead, they may opt to control their own alpha generation, through stock selection and sector and factor timing, which has now become much more feasible through the increasing granularity of exposures within the ETF market.

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

Wrapping up

The investment landscape is more complex than a binary option of 'active versus passive'. Investors should blend investment strategies and seek varied return sources in cost-efficient ways – but overall, there is no 'one-size-fits-all' solution.

The following framework has been designed to help guide investors, who want to control and manage their own portfolio, to identify the most appropriate investment strategies for their needs.

Whilst it provides a guide to building an efficient and effective portfolio, we understand the complexities of deciding what to do with your money. At BlackRock, we also offer a range of models which allow investors to outsource some of these decisions around asset allocation or fund selection to help investors tackle such challenges.

Blending investment strategies

- **Index strategies** can be deployed at the core of the portfolio to express broad market views. The growth of this is prevalent in an environment in which end-investors are increasingly focused on cost, on the back of greater fee transparency and an ever-growing competitor landscape.
- **Factor strategies**, and looking at an investor's portfolio through a factor lens, can help ensure that the portfolio is exposed to diversified factors and those relevant to the current economic regime. By understanding the style tilts that an investor wants to express, and then taking a more targeted approach to adopting factors within the portfolio, can help to generate portfolio outcomes more efficiently. This means gaining a clearer picture of which factors are driving returns and ensuring that allocations exist to genuine alpha opportunities and not just those driven by static factor tilts.
- **Long-only active equity strategies** are important to help generate additional returns from factor timing and security selection. Investors should be selective and conduct ongoing manager due diligence to find managers that are able to generate alpha, net of fees.
- **Hedge fund strategies** can provide additional portfolio diversification as well as the ability to earn excess returns from short positions regardless of the market environment.
- **Private markets** are becoming much more accessible. By freeing up risk and fee budget elsewhere in the portfolio, investors can invest a portion of their assets in private equity investments with the ability to earn additional illiquidity premia and increase diversification through returns less correlated to economic growth regimes.

Overall, we find that an outcome-optimised equity sleeve, guided by risk and fee budgets, will often result in a mix of investment strategies, even within the same asset class.

Index and factor strategies can be used to take control of broad market and factor views and manage cost, risk and time budgets, whilst then freeing up more fee and risk budget to allocate towards high conviction alpha-seeking strategies, hedge funds and private market investments, whereby a more consolidated and selective approach can lead to an increased likelihood to provide positive 'true alpha' for the portfolio.

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.

Risk Warnings

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