Unconstrained Investing

The Freedom to Perform

What exactly is 'unconstrained investing'? More importantly, why do investors increasingly need to consider this key investment strategy as a complement to their equity allocation? This paper explains the significant return, risk and diversification benefits that unconstrained strategies can bring to portfolios.

Standard Life Investments

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Introduction

Stock market indices worldwide have rallied significantly since the depths of the financial crisis. This comes at a time when economic growth, while recovering, can still generally be characterised as slow-to-moderate. Against this backdrop, equity investors are understandably becoming increasingly selective, seeking ever more sophisticated ways to generate return and to outperform. This has given unconstrained investing greater prominence, as investors hunt for the best possible risk-adjusted returns. With 'unconstrained' meaning different things to different people, in this paper we outline Standard Life Investments' approach to unconstrained investing, its attractions and why the strategy increasingly resonates with a growing number of investors. We also review some of the common misconceptions about this rapidly growing area of equity investing, particularly the perceived riskiness of the approach.

What is unconstrained investing?

Unconstrained investing is an active equity investment strategy that seeks to exploit opportunities across the broader market, irrespective of the companies' weightings in stock market indices. This contrasts with many active equity funds, which choose to reference portfolio construction relative to a particular benchmark index. The practicalities of this mean that investors can, unwittingly, become exposed to unintended risks that could ultimately impair the returns achieved. In contrast, an unconstrained approach aims to maximise investor returns through more active investment and risk management.

Despite its title, unconstrained investing is not an approach that is completely unfettered and without rules – controls still apply. An unconstrained equity portfolio will still have to adhere to maximum stock or sector size limits, although these will typically be far more generous than those afforded to more mainstream equity portfolios. The UCITS rules regarding mutual fund position sizes equally apply to unconstrained portfolios. For example, the 5/10/40 rule stipulates that a maximum of 10% of a portfolio's net assets can be invested in the securities of a single issuer, while investments of more than 5% with a single issuer cannot make up more than 40% of the entire portfolio. This ensures a degree of diversification for clients' protection.

Strictly, then, 'unconstrained' refers to the strategy's greater freedom to invest right across the market when compared with the more benchmark-constrained strategies commonplace in the market today. There are several advantages to an unconstrained approach.

Broader opportunity set

Many managers referencing a benchmark for portfolio positioning tend to be heavily influenced by the index's concentration in a small number of companies or sectors. Understandably, some managers can be apprehensive about deviating too far from constituent weightings in a benchmark index. Consequently, this can result in an unnecessary skew towards certain industries, which may not display the most attractive investment characteristics. Unconstrained portfolio managers are able to avoid the concentration risk inherent in some single country indices like the UK for example.

The flexibility of unconstrained investing enables the manager to invest across the full market-cap range and all sectors, allowing him or her to avoid holding stocks with little or no investment merit. If an unconstrained manager does not favour a particular company or industry, there is no requirement to invest. Only where the manager has the highest conviction in the investment case will they hold a stock.

Best ideas only

Greater flexibility means that unconstrained portfolios are better able to deploy their resources to faster-growing areas of the market and to access a larger number of companies benefiting at different stages of the economic and investment cycle. Consequently, the manager can focus on finding the best ideas for the portfolio, those justified by rigorous bottom-up analysis of each company's business fundamentals.

This conviction-led approach to investing means that there are none of the artificial biases that can result from benchmark-driven investing. In turn, unconstrained investment managers can therefore focus solely on stock selection to drive the bulk of returns.

"Unconstrained investing is not an approach that is completely unfettered and without rules"

A more active approach

One of the key differences between unconstrained investing and traditional benchmark-related approaches is the former's flexibility to avoid weightings in large benchmark constituents if the company fundamentals do not warrant it. This can mean unconstrained portfolios exhibit higher 'active share', the percentage of a portfolio that differs from the benchmark index.

By contrast, the bias of benchmark-aware portfolios towards large index-weighted stocks can lead to low active share, as a greater percentage of portfolio capital is tied up in these holdings given their size in the benchmark.

Some academic studies have concluded that investment managers exhibiting higher levels of active share, rather than higher tracking error for instance, are more likely to outperform their benchmark. Recently, however, the metric has been subject to some debate in industry and academic circles regarding appropriate usage and interpretation. While it can differentiate high-conviction managers from so-called closet index trackers, active share should be seen as just one useful investment metric among the many variables investors should consider when choosing a fund for investment.

Indeed, it is important to be aware why active share can be higher for a particular fund. Benchmark composition is one key variable. Particularly concentrated indices, such as the UK, which is dominated by oil & gas and basic materials companies among others, can influence active share statistics depending on the extent of the portfolio's exposure to these sectors. Meanwhile, tracking error (a measure of how closely a fund follows the index to which it is benchmarked – effectively a 'risk budget') can be another important factor. Some funds have more modest performance targets and therefore scale the risk adopted accordingly. For instance, a more modest target of, say, 1.5% in excess of the benchmark return will usually require a lower tracking error limit, and active share could consequently fall below the 60% considered to be the threshold for genuinely active funds.

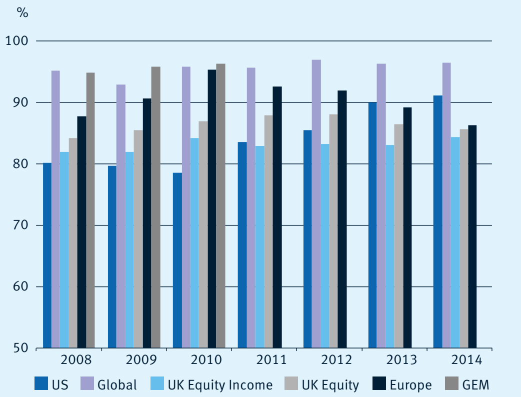
Chart 1 displays the active share statistics for the Standard Life Investments unconstrained range over time. Running for a number of years, these funds have exhibited consistently high active share. Importantly, however, these active share levels are an output of our investment process, not a target. Such high active share is the result of the investment managers' high conviction in the individual stocks selected for the funds.

High-conviction investing

An unconstrained approach ultimately gives investment managers the freedom to express their deep, stock-level insights to the fullest possible extent without consideration for potentially inhibiting benchmark constraints. The discretion to invest in the highest-conviction ideas, without any unintended style or market-cap biases, means that unconstrained investing allows for a purer expression of stock picking and a much more active investment approach.

While unconstrained portfolios may charge more, investors should consider annual management charges together with alpha generation potential. In effect, investors pay for access to a higher proportion of best ideas. The performance potential of unconstrained portfolios can mean it is worth doing so. A narrow focus on the costs alone, rather than the overall value provided, could result in paying only slightly less for exposure to what can be only market-level returns.

Chart 1: Standard Life Investments range active share



Source: Northfield

"Active share should be seen as just one useful investment metric...when choosing a fund for investment"

Debunking the risk myth

Unconstrained approaches to investing have existed for some time, but the recent rise in investor interest has fostered several misconceptions about the approach. The strategy's inherent flexibility has led to a perception of riskiness, with some investors fearing that 'unconstrained' is simply cover for investment managers to do as they please. Related concerns include the types of stocks held by unconstrained portfolios, the potential for unintended style or market-cap biases, turnover levels and liquidity constraints. In truth, unconstrained mandates are subject to a high degree of control, with rigorous risk management a prime consideration.

Given some investors' concerns regarding risk management in unconstrained portfolios, we examine in detail some of the most common misconceptions surrounding risk and unconstrained investing.

Risk versus volatility

Volatility – unavoidable, but transient

When examining perceived riskiness, it is particularly important to distinguish between risk and volatility. The two are not the same. Given the greater bottom-up focus of unconstrained portfolios, they can display higher-than-average volatility over the short term compared with benchmark-related portfolios. However, volatility is not a measure of risk in its entirety. Volatility is typically only seen over shorter time periods and is generally unavoidable. Volatility generally washes out over longer timeframes, entirely consistent with the longer holding periods typically recommended for equity-based investments.

Risk – essential to outperform

Risk, in contrast, is considered and actually necessary – the need to take risk to gain reward is a well-recognised investment maxim. However, all risk is not the same and it is important to be aware of the type of risk being adopted. In the process of constructing portfolios, equity investors can become exposed to market and factor risks, as well as stock-specific risks.

Taking the right risks

The goal is to maximise exposure to stock-specific risk, the risk attributes particular to that one company, where bottom-up equity investment managers can be expected to have an information advantage and non-consensus insight. Investors pay investment managers for these insights and their stock-picking expertise in order to maximise returns by taking considered, stock-specific risks within a diversified portfolio.

As reflected in their higher active share relative to benchmark-related peers, unconstrained portfolios' lack of benchmark restrictions allows them to focus more on the 'right' kind of risk, stock-specific risk. Other risks, such as sensitivities to interest rates or oil prices, can be acquired when constructing a portfolio and may either help or hinder performance. However, these are risks where a bottom-up equity investment manager is less likely to have an information edge over the market. The obvious task is to minimise such factor risks and maximise stock-specific risks to best exploit the manager's expertise.

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Benchmarking and unwanted risk

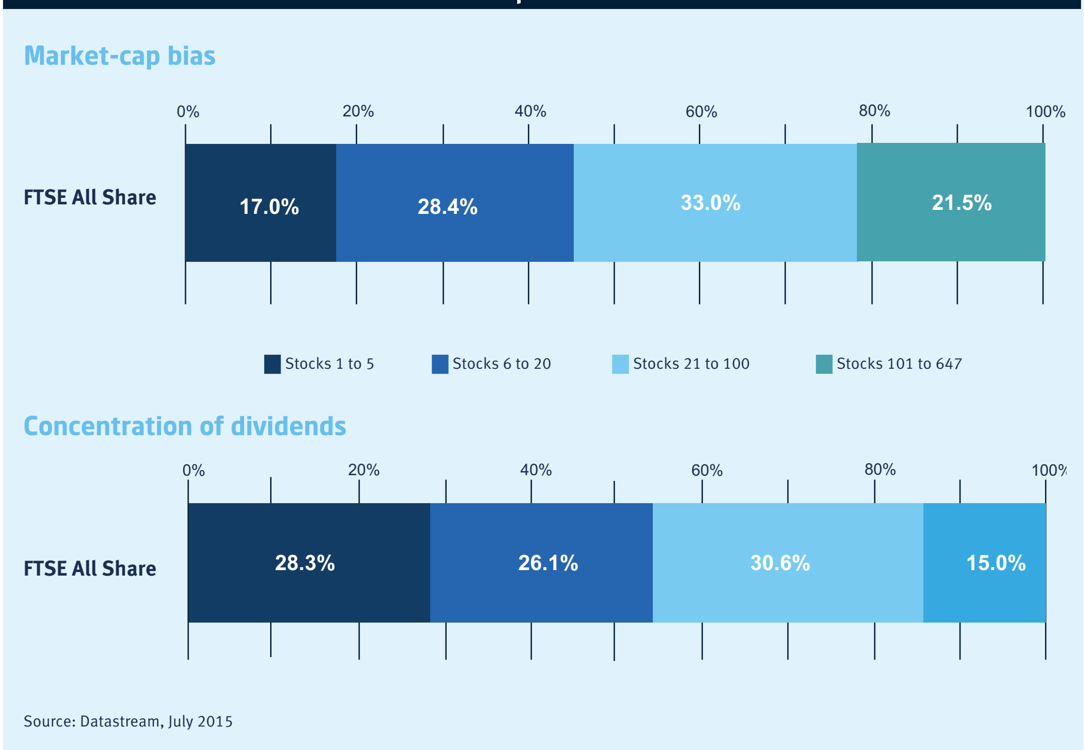
Benchmarks are not risk free
Given the focus on considered stock-specific risk, concerns among investors about the 'riskiness' of unconstrained investing appear to be misplaced. Ironically, this perceived riskiness is often defined relative to benchmark-focused portfolios – benchmarks themselves are not risk free.

Reference indices effectively reflect the consensus pricing of all stocks in the market place and consensus is not always right. The essence of stock picking is to challenge consensus and to avoid following the herd. Using a benchmark as a risk anchor can therefore amount to tacit admission that one should follow the crowd. This is why traditional risk metrics such as 'tracking error', a measure of the divergence in performance between a portfolio and a reference index, are not particularly appropriate for unconstrained portfolios.

The lower active share typically seen in benchmark-related portfolios already places them at a potentially considerable performance disadvantage when compared with unconstrained portfolios, since they take far less exposure to stock-specific risk. However, this can be compounded by other unintended risk exposures. With significant resources invested in large, benchmark-weighted stocks, index-referenced strategies can effectively end up mimicking the index. The consequence is higher exposure to market risk, rather than to the underlying stock-specific risks many investors expect.

Many worldwide stock markets, particularly single country indices, exhibit some degree of concentration. This is true in certain developed markets in Europe and North America, as well as in selected emerging market countries. By way of example, Chart 2 displays the situation in the UK, where FTSE All-Share Index market capitalisation and dividend payouts are dominated by only a small handful of large companies.

Chart 2: Index concentration – the UK example



Source: Datastream, July 2015

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Diversification

Unconstrained investing reduces concentration risk

The heavy concentration of some benchmarks in mature, large-cap stocks and sectors makes their choice as a portfolio construction anchor inherently risky itself. The choice of benchmark becomes critical, as choosing the wrong one can have a material impact on performance. Despite perceptions of their riskiness, the flexibility of unconstrained mandates to avoid fundamentally unattractive holdings can mitigate issues such as concentration risk. This means managers can focus on exploiting their greatest non-consensus insights.

Unconstrained investment managers have high sector and thematic risk awareness, monitoring any potential size, sector or country skews and actively mitigating these risks.

Beta in disguise?

Unconstrained does not necessarily mean beta

A further misconception about unconstrained mandates is that they are directional bets on the market or 'beta plays', beta being a statistical measure of a portfolio's sensitivity to market movements. A beta greater than 1 indicates that the fund will move more than the market in the same direction and vice versa.

In general, unconstrained strategies cannot be pigeon-holed into one particular style. They do not necessarily take pro-cyclical risks as a matter of course, but have beta flexibility. An unconstrained portfolio's beta is not predetermined, but is the outcome of the individual stocks chosen on a bottom-up basis and, importantly, such mandates do not necessarily need a high beta to outperform.

Chart 3 summarises the key risk characteristics of a range of unconstrained portfolios managed by Standard Life Investments. These are provided purely as representative examples of unconstrained portfolios in general. The data illustrate the investment restrictions and risk parameters that are applied. In general, these unconstrained portfolios take no view on market direction, preferring instead to let the underlying stock positions drive portfolio returns.

Chart 3: Risk metrics

	American Equity	Global Equity	UK Equity Income	UK Equity	Global Emerging Markets	European Equity
Maximum position size	5%	5%	5%	5%	5%	5%
Sector limit	30%	30%	30%	30%	30%	30%
No of stocks	30-60	30-60	30-60	30-60	30-60	30-60
Minimum sector exposure	Min of 5% in at least 4 sectors	Min of 5% in at least 4 sectors	Min of 5% in at least 4 sectors	Min of 5% in at least 4 sectors	Min of 5% in at least 4 sectors	Min of 5% in at least 4 sectors
Maximum cash	5%	5%	5%	5%	5%	10%
Active share	90%	96%	82%	87%	97%	88%
Predicted tracking error	4.4%	5.0%	4.7%	5.1%	6.5%	4.6%
Predicted beta	1.06	1.11	0.99	1.25	1.00	1.03

Source: Northfield, 29 May 2015

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Managing risk

Reducing unintended risk
Not using a benchmark as a risk anchor can mitigate concentration risk. However, this is not the only risk that unconstrained investment managers face. As a result, a more holistic and disciplined risk management process is deployed to monitor and mitigate the other risks that may be present, and where the manager has less of an information advantage. This involves a layered approach, with analysis conducted at both a qualitative and quantitative level.

- **Qualitative analysis** is conducted by the manager and analysts on the sector, thematic and macroeconomic risks being adopted in the portfolio. This ensures that total portfolio exposure is understood and does not become excessive – an essential discipline to establish that the portfolio is suitably diversified.
- **Quantitative analysis** is carried out to understand the de facto risks the investment managers are taking and to act as a 'sense check' to ensure they are satisfied with them. Industry-standard risk models such as Northfield can be used and are particularly helpful in mitigating the factor risks which managers may acquire through the stocks selected. This can then be supplemented by portfolio simulation to ensure these factor risks do not overwhelm the portfolio and to enable the manager to ensure suitable diversification.

Ultimately, the risk adopted is a function of the stocks the manager likes, with the risk process ensuring that the manager remains aware of the risks present at all times.

Risk-adjusted returns are key

Risk considerations are paramount
The high risk-awareness of unconstrained investing ensures that the best possible return is achieved for the lowest possible risk. It is this pursuit of risk-adjusted returns that is critical in unconstrained investing, a fact often overlooked in the sometimes oversimplified risk debate.

The investment research and risk analytics inputs into managing unconstrained funds are considerable. Consequently, those asset managers with sufficient scale and resource should be able to generate consistently the investment ideas likely to maximise the performance potential of a concentrated portfolio.

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Portfolio construction

The focus on risk-adjusted return is central to position sizing when constructing an unconstrained portfolio. The manager ensures that appropriate due diligence on stock-level risk characteristics and their impact on the overall portfolio is conducted and understood before a stock is purchased.

Stocks are then included on the basis of absolute positioning, rather than relative to a weighting in a benchmark. If a particular stock is considered more risky, absolute position size is limited accordingly, even if it offers significant upside. The reverse is also true: stocks with perhaps less upside but offering important diversification attributes may justify a larger position size. Unconstrained mandates are not simply a best ideas buy list. The funds are actively managed at the portfolio level, deploying detailed risk analysis to blend the best possible profile of risk-adjusted returns.

This pursuit of optimal risk-adjusted returns is key in enabling unconstrained investment managers to focus purely on adding alpha, a measure of excess return. The ability to focus only on the best, highest conviction ideas ensures that only those stocks the manager believes will outperform are included. This is broadly reflected in the number of stocks held by unconstrained portfolios, which are typically more concentrated, holding around 40-50 different positions.

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Positioning

The misconceptions surrounding risk have led to a somewhat oversimplified and superficial all-or-nothing approach to the suitability of unconstrained portfolios. A general view has resulted that they are therefore inappropriate for anyone other than the most risk-tolerant investors. This appears extreme when considering their advantages over other more traditional approaches to active equity investing and that unconstrained strategies are unlikely to be the only solution when building a client portfolio.

Unconstrained – a key part of the investment mix

Rather than be viewed in isolation as a standalone, one-size-fits-all solution, unconstrained strategies should be considered more appropriately within the wider context of an investor's overall portfolio and be seen as an important additional diversifier. Unconstrained strategies could add value to all types of investor depending on the composition of their overall portfolio.

Matching exposure with client needs and objectives

Equities' risk and return characteristics mean that they should still be seen as a medium to long-term asset class. While such an investment horizon would enable investors to deal with unconstrained portfolios' greater potential for higher short-term volatility, this may still dissuade more conservative investors, despite the attraction of this approach.

Whatever the rights and wrongs of this standpoint, advisers managing client assets or recommending particular courses of action will clearly need to balance the benefits of unconstrained investing with specific client types based on risk/return tolerances. This places the emphasis not on the black-or-white appropriateness of an unconstrained approach in its own right, but on client portfolio management and how such unconstrained strategies may be used, and in what proportion, in a wider portfolio context to improve client outcomes. The question is not one of 'if', but 'how'.

Better use of risk

In particular, unconstrained strategies may be useful in helping defined benefit pension plans to square the circle of generating sufficient return to meet longer-term liabilities while continuing to de-risk. Unconstrained mandates' focus on risk-adjusted returns may allow such pension funds to continue to benefit from equity-like returns without some of the attendant risks of traditional equity funds.

The requirement for these pension plans to de-risk is well documented, but leaves them targeting a higher return from a smaller equity weighting. One solution for trustees to consider is to re-position their equity allocation, even if only partially, towards unconstrained strategies. With a focus on boosting exposure to considered stock-specific risk and on minimising those risks where the manager can add less value, unconstrained mandates can increase return potential per unit of risk and may ensure more efficient use of shrinking risk budgets.

"Unconstrained strategies are unlikely to be the only solution when building a client portfolio"

Conclusion

Unconstrained portfolios clearly enjoy greater freedom to invest right across the wider market, bringing a number of benefits for investors:

- **minimal focus on benchmark indices and therefore reduced concentration risk**
- **a focus on improved diversification**
- **higher active share and therefore greater performance potential**
- **more efficient use of risk budgets**
- **value for money.**

Consequently, unconstrained strategies are arguably one of the purest forms of stock picking available, allowing the investment manager to express deep stock-level insights to the fullest extent in the pursuit of superior risk-adjusted returns.

Risk is ever-present in equity investing and cannot be fully removed without potentially impairing return expectations. Adopting some risk is essential to target the outperformance many investors seek. That risk should be stock-specific risk in order to fully capitalise on the investment manager's stock-level insights. Defining perceptions of risk relative to an admittedly widely followed but nevertheless fundamentally flawed risk anchor, such as a benchmark index, is inherently risky itself. Continuing to approach risk in this way can leave investors over-exposed to the type of risks where a manager has fewer opportunities to add value and that unconstrained portfolios actively seek to mitigate.

Far from being risky, unconstrained investment strategies are highly risk aware. A number of processes and tools are deployed to monitor and manage unwanted risks. Ultimately, portfolio positioning may be benchmark agnostic, but not risk agnostic. The focus on the 'right' stock-specific risks and the resulting high active share ensures that investors are solely exposed to the best ideas of the managers and their teams. The key focus is therefore not risk versus no risk, but rather taking the right risks in the right proportions for the return available.

Unconstrained investing's bottom-up, risk-aware approach can significantly enhance performance outcomes, as these portfolios have the highest exposure to the firm's best ideas. Consequently, they can also actually represent better value for investors. Fees are only slightly higher, yet the long-term alpha generation potential when compared with mainstream active investment strategies should more than compensate.

Unconstrained strategies are unlikely to be the only solution for investors, but rather have their place as part of an overall portfolio. Indeed, unconstrained portfolios' differentiated approach and stock-picking focus can be highly valuable diversifiers, allowing investors to benefit from genuinely active equity investment and superior return potential. Their more targeted risk approach can also allow more efficient use of risk budgets for those clients seeking to de-risk. Consequently, the debate appears to be less about whether such strategies are suitable at all. Instead, it is about how they can best be incorporated into client portfolios in the right proportions to capitalise on their attractions and improve overall client outcomes.

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