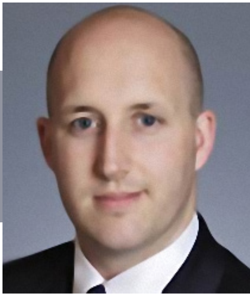

From the desk of Alex Duffy

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A comment on portfolio construction

Turning over many stones and 'stock picking' within the investment universe is the bread-and-butter of most active managers. However, while this is a critical part of the investment process, it's only one part of the process. Cobbling those stones together and ensuring that they receive a weighting in the end portfolio commensurate with the risk–reward payoff requires an altogether different skillset.

Portfolio construction all too often appears as an afterthought for many active managers, yet it is ultimately critical in determining the investment returns and volatility of returns for investors in the underlying portfolio.

The greatest risk that we as investors face is the permanent loss of capital – if we put $100 into a business and don't get $100 back. In my opinion, portfolio construction should manage this risk; therefore, the amount of capital we are willing to put at risk on a particular stock should reflect the maximum amount of capital we are willing to lose if we are wrong, versus the probability of that negative outcome occurring.

Over the last decade or so, the fixation on tracking error, active money and other 'risk' management measures (which are implicitly determined by the nature and construction of the respective indices against which portfolios are often judged), has led investment managers to neglect the 'real' risk their clients are attempting to mitigate.

In my view, such a response too often leads to final investment outcomes and portfolio structures that are not aligned with original objectives. This results in stocks being allocated capital not in accordance with conviction or the balance of the risk–reward that the stock offers, but rather with how large the stock is within the index, or in order to mitigate some other perceived risk presented by the fund being over- or underweight in a given sector, geography or investment theme.

Determining how much capital we should put at risk in a stock starts with a thorough understanding of what the downside could be, should we be wrong. Using this as a starting point enables me to draw an approximate 'line in the sand' for a particular stock. Once this has been achieved, I set about understanding the range of payoffs to the upside should our investment thesis prove correct. My focus is very much on the sustainability and duration of returns, the range of possible outcomes for the return profile of a business, and the probability of our analysis proving correct on any one of those outcomes.

Every position within my portfolio is there on the merits of a thorough analysis: the strengths and weaknesses of the business model, the return profile of the business, the reinvestment opportunity the business is faced with, and the starting valuation at which we are able to acquire that particular future cashflow stream.

The final position size of an individual stock ultimately reflects our conviction on a given outcome and, critically, places greater weight on those stocks that have a high probability of consistently meeting – and potentially beating – our hurdle rate, rather than those which, on the toss of a coin, may handsomely beat yet equally may significantly under-perform it.

While this may result in a portfolio that looks different from the standard MSCI Emerging Market Index, against which the performance of the portfolio is judged, it is a portfolio that we feel better encapsulates the real risks our clients face.

An additional layer of the portfolio construction process then considers and seeks to mitigate the overall real endogenous and exogenous risk factors that the portfolio is exposed to.

More specifically, once a company has passed the scrutiny of our stock level analysis, we then turn to the role it plays in the overall makeup of the portfolio – emphasis being given to the correlation of the cashflow drivers of that particular company with the cashflow drivers of other stocks already held. This focus on intra-fund correlation is an additional layer of absolute risk mitigation, which implicitly leads to a moderation of the portfolio's relative risk versus its index or universe.

These factors combined provide a portfolio that is constructed in an absolute fashion, with stocks being allocated capital on their own individual merits, irrespective of their relevance to a particular index, yet with an overall construction process that helps to ensure against excessive risk.

As the portfolio manager, I can truly stand by every investment decision and position size within the portfolio. As a client invested in the fund, I know I'm in a fund that is actively managed, appropriately considers the real risks I am faced with, and still provides the exposure I'm seeking when investing in emerging market equities as an asset class.

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