September 2022

This Is Not Normal: What's An Active Equity Manager To Do

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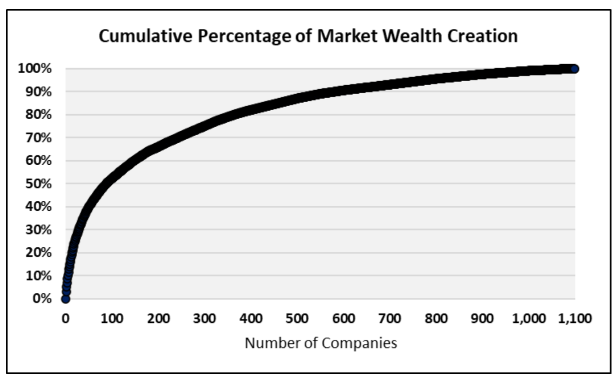
The distribution of returns for the universe of individual equity investments does not produce a neat normal distribution with winners and losers symmetrically positioned around the median-performing company. Instead, returns to the equity asset class have been driven by a minority of strongly performing companies, or what statisticians refer to as a positively skewed distribution. Given that a stock can only lose one hundred percent of its market value but its theoretical gain is unlimited, this should not be overly surprising. The implication of this phenomena for an active equity manager is that the deck is stacked against you in selecting an outperforming company but there are steps that can be taken to increase the odds of success.

Nowhere is this idea of an outsized failure rate more pronounced than in Venture Capital startup investing where asset class returns are driven by a small number of big winners – so-called unicorns - that compensate for the hundreds of startups that disappear into obscurity. From a universe of over 10,000 technology-related startup companies funded from 2011 through 2014, only one in five survived to subsequently be acquired or, for many of the most successful, progress to an initial public offering[1]. In fact, only slightly more than half of the companies were even successful in raising a second round of funding.

The concept holds with publicly traded stocks as well, if less pronounced. A 2018 study[2] found that on average only 43% of public stocks from 1926 through 2016 had a buy-and-hold return that exceeded that of Treasury Bills. In fact, less than one-half of the monthly returns were even greater than zero despite the 10% long-term market capitalization-weighted return to the US stock market as measured by the S&P 500 over the life of the study.

Measuring the contribution to the cumulative wealth creation in the US equity market over the 90 years of the study highlights the impact of positive skewness in publicly stock returns. With more than 25,000 companies having issued public equity over the life of the study, just 5 companies were responsible for 10% of the total value creation (familiar names ExxonMobil, Apple, Microsoft, General Electric and IBM) and half of the aggregate wealth creation of $35 trillion was sourced from only 90 companies. Further, roughly 1,100 companies, or 4% of all listed companies over the period were responsible for the entire value creation in the US market; in other words, 96% of the listed companies over the 90-year period added no value above T-Bills in aggregate.



Source: Hendrik Bessembinder, "Do Stocks Outperform Treasury Bills?", Journal of Financial Economics, May 2018.

[1] "Start-Ups Success Rates and Repositioning for the New Normal", Forbes, May 27, 2020.

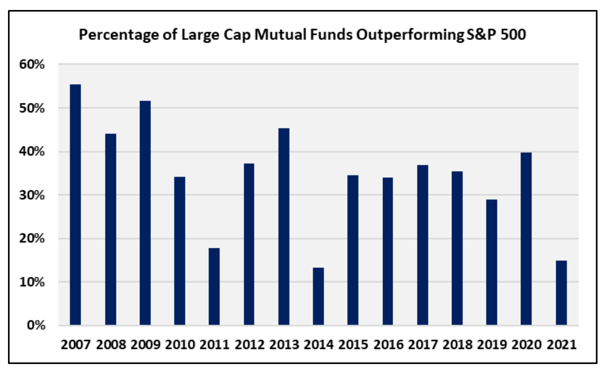
[2] Hendrik Bessembinder, "Do Stocks Outperform Treasury Bills?", Journal of Financial Economics, May 2018.

While these statistics certainly catch the eye and serve as a striking example of the power of compound returns, the above analysis on the skewness of returns when viewed through the lens of an institutional investor loses much of its shock value. This is because the bulk of the poor performance is concentrated in the small capitalization end of the spectrum and as one moves up the market capitalization range to the large- and mid-cap regions inhabited by institutional investors, the success rate of individual stocks improves markedly. Skewness remains but to a lesser extent.

An ensuing analysis[3] found that the median large cap stock comfortably outperformed the T-Bill return over the 1963-2020 period. When the universe was limited to the largest 500 companies, comprising roughly three quarters of the US market capitalization, 59% of companies outperformed T-Bills with a median return of 8.5% versus a return of 4.5% for T-Bills. Extending the universe to the next 1,000 largest stocks, encompassing a further 21% of the US market capitalization, 57% of these companies outperformed T-Bills with an excess return of 3.7%. Combined, the 96% market cap weight of these 1,500 companies represent the bulk of the investable universe for institutional investors and are contained in market cap deciles 7-10 in the chart below. Not until the market cap slips below decile 7, where any such holdings are likely to have a negligible impact on institutional portfolios, has the success rate versus T-Bills dipped below 50%.

Of course, active equity managers do not earn their fees by outperforming T-Bills but by topping their equity benchmark, usually a market-capitalization weighted index. While the large-cap end of the spectrum has historically exhibited a more normal return distribution than the small- and micro-cap end, stock market returns in recent years have been particularly top-heavy as the mega-cap Technology companies such as Apple, Microsoft and Google parent Alphabet have come to dominate the indices.

This has created an extremely challenging environment for active managers with an average of only 47% of large cap stocks outperforming the index each year over the years 2011 through 2020[4]. Indeed, in only two of those ten years did more than half of companies top the aggregate index return. The reluctance of most managers to include the mega-cap companies in their portfolios, at least at their respective weightings, goes a long way in explaining the disappointing performance logged by active US investors over the last decade, represented in the chart below which shows 2009 as the last year in which more than half of active large cap mutual funds in the US topped the S&P 500.



Source: Gene Hochachka, "The Distribution of US Stock Returns, 1963-2020"; Frontier Financial, Inc., June 2022.

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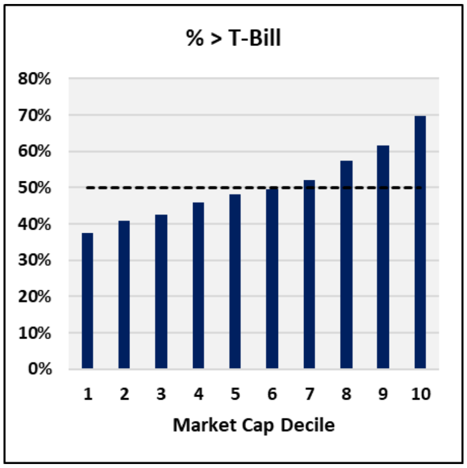
[3] Gene Hochachka, "The Distribution of US Stock Returns, 1963-2020"; Frontier Financial, Inc., June 2022.

[4] John Rekenthaler, "You Needn't Hold Your Stock Winners", Morningstar, May 2021.

The foregoing analyses prompt several implications for active managers in overcoming these roadblocks to superior performance.



Source: S&P SPIVA US Scorecard, Year-End 2021.

First, in large cap stocks where the investable universe has exhibited a more normal return distribution for individual stocks, managers should avoid expending too much of their risk budget in actively positioning their portfolios with respect to market capitalization. As mentioned, active large cap managers have tended to underweight the largest stocks in the universe and emphasize holdings lower in the capitalization spectrum of the large cap universe, a strategy which has demonstrated to be detrimental to their performance, especially over the last decade. This tendency to underweight the mega-caps has produced additional performance drag from the accompanying implicit anti-momentum stance. By underweighting the most successful companies in the universe they are betting against what has historically been a persistent source of return premium in the momentum factor.

The small cap area is confronted with its own set of implications from the shape of the return distribution. Due to the more skewed nature of the return distribution in smaller capitalization stocks, active managers there could be better served spending more of their risk budget in security selection. With an outsized reward for skill in identifying the extreme positive performers, they should be more willing than their large cap counterparts to take on more risk for the prospect of identifying these companies. This willingness to assume greater security selection risk is often achieved through concentrating the number of portfolio holdings, focusing on only the highest conviction investments and avoiding the potential pitfall of over-diversification in a non-normally distributed universe.

However, merely concentrating the portfolio does not by itself ensure better-than-benchmark performance in the absence of investor skill to discriminate between tomorrow's winners and losers. In addition to this rare skill, the concentrated approach also calls for a high degree of patience with a long investment horizon, i.e., not only identifying Google as a superior investment to long-forgotten internet search pioneers Lycos and Excite but having the fortitude to hold the company for years through its inevitable peaks and valleys. In a world of short attention spans and high portfolio turnover, such patience is also equally rare. Managers of concentrated portfolios also face a host of risk budgeting challenges of their own as their search for the best opportunities result in unbalanced portfolios with respect to industry composition or factor exposures such as momentum or value that are a residual of their bottom-up stock selection methodology.

Ultimately, there is no silver bullet to active equity management and the distribution of individual stock returns presents one of many hurdles for managers to overcome in the portfolio construction process. Whether highly concentrated or widely diversified, buy-and-hold or high turnover, there is no substitute for investor skill applied in a disciplined manner.

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