RBC Global Asset Management

Holding conviction

I met a colleague recently who told me that he invests in global equities but wasn't sure how to choose a strategy amongst hundreds of alternatives. He asked me: "What would be the one thing I should look at when trying to select a global equity strategy?"

Put on the spot, I quickly considered possibilities: what about the usual trinity of 'people, philosophy and process'? Too many and too qualitative. ESG? Too complicated. Performance? Too blunt.

So in the end I answered "the number of holdings".

It is a simple measure, which may be helpful when filtering a universe. But it also is an indicator of a couple of important characteristics, the first of which is conviction. This is an important contributor to relative performance, as it suggests something about the strategy's investment philosophy, or why an investment manager selects certain investments, but rejects others. It is this selection that creates differences between the portfolio and the broader market, allowing the strategy's performance to divert away from the market, generating out or under-performance.

> **"Too few holdings, therefore, could imply a portfolio that is insufficiently well-diversified, making it susceptible to those unintended incidental risks dominating the investment returns."**

The inference is that the lower the number of holdings, the greater the conviction in those holdings. We tend to all know what we really like, but only up to a point. If in doubt, just ask yourself what your two favourite ice-cream flavours are (mine are vanilla and chocolate, despite an occasional dalliance with salted caramel). Now, try to determine your eighth and ninth favourite flavours. Accurately ordering them isn't easy and neither is being able to say how much more the eighth is preferred to the ninth.

It is the same with investment ideas. Each incremental holding is not expected to be as good as the ones that precede it. Yet each new holding will be funded with capital that could have been invested in some of those better ideas. This diversion of capital from good ideas to less good ideas imposes an opportunity cost on performance.

But it isn't necessarily the case that fewer holdings is always better. Just like the ex-British prime minister Harold Macmillan, who, when asked what had been the greatest influence on his administration, replied "Events, dear boy, events", portfolios with too few holdings can be blown off-course by the unexpected.

Additional holdings may improve the overall investment experience by adding diversification. Investing is all about being rewarded for taking risks and every holding will bring with it exposure to a varied number of risks. Many such risks may be considered desirable and make the holding attractive. But there will also be other unintended risks incidental to the investment thesis. For example, investors might be drawn to the attractiveness of a particular company based on its brand and technology but be unconcerned about where the company is listed. Should the country of listing be affected by an 'event', the portfolio returns may be compromised. Fortunately, this 'country risk' may be mitigated through diversification by holding a portfolio of companies from a selection of different countries.

Too few holdings, therefore, could imply a portfolio that is insufficiently well-diversified, making it susceptible to those unintended incidental risks dominating the investment returns.

Unfortunately, the investment environment is complex and 'events' are not uncommon. There are many such sources of unintended incidental risk. This leads to an inevitable tension between having fewer holdings to preserve conviction and adding additional holdings to diversify incidental risks.

Managing this trade-off is one of the challenges of efficient portfolio construction and investors' opinion of their optimal portfolio will vary with the degree of risk they are comfortable taking. But it is widely acknowledged that there comes a point after which the diversification gains from adding each additional holding begins to diminish. Moreover, each additional holding will lower conviction, until ultimately the portfolio's return will be indistinguishable from that of the market. That may be fine if one is looking for broad equity exposure, but would be problematic if one is paying a management fee in the expectation of outperformance.

The number of holdings is also a key variable in the consideration of environmental, social and governance issues, or 'ESG'. These are often contextual issues, requiring judgement, and may only become apparent over time. But taking the time to investigate them and then incorporate them into the investment decision actually adds to overall conviction. It supports better-informed decisions and thus, improved investment outcomes.

The difficulty is that ESG takes time and resource, both during due diligence prior to investing, and then post investing through active engagement. It is an opportunity to enhance investment returns, but becomes harder and harder to do, and do well, the greater the number of portfolio holdings.

There is much that is relevant to the selection of a strategy that is omitted from a simple datapoint such as the number of holdings, so it should not be the only thing relied upon when making a selection. A more detailed and considered analysis would likely uncover additional aspects worthy of consideration and an investor's own preference for risk is also important. But having been put on the spot by my colleague, and having since had time to reflect upon my answer, I remain of the opinion that the number of holdings is as good a starting point for investigation as any, offering as it does a window into conviction, investment philosophy, risk management and ESG.

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Publication date: December, 2021

GUKM/21/206/DEC23/A

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