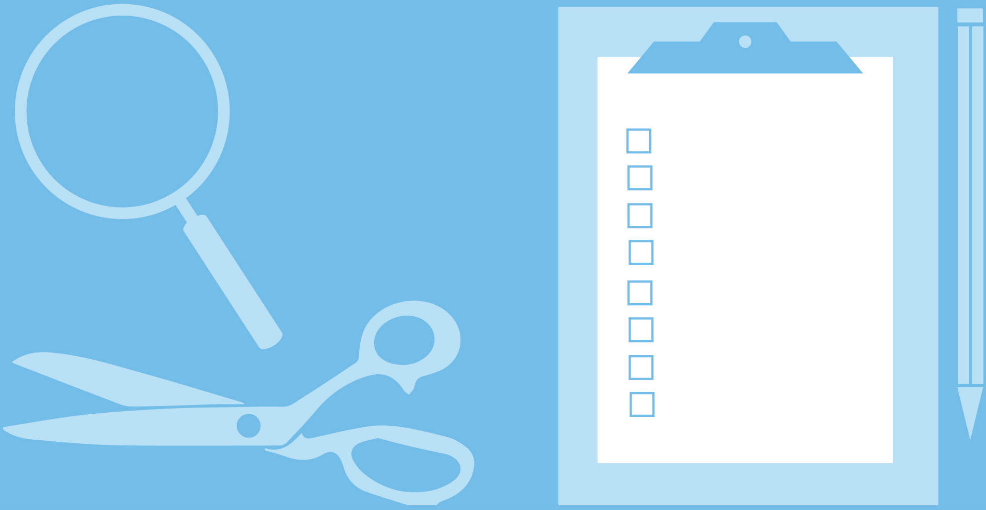

Portfolio precision

While SKAGEN's philosophy has remained unchanged for nearly 25 years, our investment process has developed over time. As a result of the refinements, our largest equity funds have slimmed down to their highest conviction investment ideas.

In this article, we explore:

- Why investors should be increasingly selective to optimise returns and minimise risk
- How our largest equity funds have slimmed down to their highest conviction investment ideas
- Why concentrated portfolios can maximise upside potential and downside protection

As a growing number of central banks look to tighten money taps around the world, an important side-effect for equity investors is that company fundamentals should drive their stock prices once again. While shareholders generally can have few complaints – the MSCI All Country World Index has almost trebled since Quantitative Easing was first announced in the US in November 2008(1) – they will probably need to invest increasingly selectively to protect their gains as the easy money dries up and the stock market correlation it has supported falls away.

Although low inflation may impact the timing and rate of tapering, the winners will be those who have lean portfolios of stocks with downside valuation protection and who have the skill to pick up the best bargains as the tide turns. For while a fund's Active Share(2) – or the extent to which it invests away from the benchmark – tends to explain the majority of outperformance, its level of concentration can also play an important alpha-generating role.

Best ideas

While SKAGEN's philosophy has remained unchanged for nearly 25 years, our investment process has developed over time. Perhaps the most noticeable change in the portfolio construction of SKAGEN Global and SKAGEN Kon-Tiki has been a meaningful reduction in the funds' number of investments over the past three years with both steadily slimming down from holding over 100 companies to 44 and 52, respectively, at the end of July.

Both funds expect to retain their streamlined profile, given the benefits it offers. Primarily, the portfolio managers can give greater backing to their best ideas; giving their highest conviction investment cases a bigger weighting creates the opportunity for significant outperformance if the holdings perform as expected.

Currently the funds' top ten positions account for roughly 43% of each portfolio, up from 31% for the global equity fund SKAGEN Global and 38% for the emerging markets fund SKAGEN Kon-Tiki in June 2014, and the higher-conviction approach is leading to strong contributions from some of our largest holdings this year. SKAGEN Global's two largest alpha generators are top-ten holdings which have a significantly higher weighting in the portfolio than the benchmark with Unilever (4.9% average fund weight vs. 0.2% average index weight) and Samsung Electronics (4.2% average fund weight vs. 0.5% average index weight) each contributing 0.64% in excess return. For Kon-Tiki, top-ten holding Naspers (4.9% average fund weight vs. 1.8% average index weight) is one of the top 2017 alpha generators, having contributed 0.35% to excess return.

Academic research also supports the idea that concentrated portfolios are more likely to outperform. A 2010 study(3) found that the best ideas of active managers generate significantly more alpha with poor performance attributable to over-diversification rather than a lack of stock-picking ability. It revealed that the highest conviction positions not only generated statistically and economically significant risk-adjusted returns over time, but they also outperformed the market and the portfolios' other stocks consistently across different benchmarks, risk models and definitions of best ideas by between 1.2% to 2.6% per quarter.

An earlier investigation(4) similarly found that concentrated managers outperformed their more broadly diversified peers by around 4.0% annually due to their biggest bets outperforming. The study's findings lend support to the idea that managers who tilt their portfolios towards their favourite stocks assess correctly the relative merits of stocks overall as well as within their portfolios, suggesting that investors may enhance performance by diversifying across focused managers rather than by investing in highly diversified funds.

This is also reflected in our portfolios. Despite the above examples, Unilever, Samsung Electronics and Naspers, delivering significant share price gains of between 26% and 44% this year(5) our portfolio managers expect significantly more to come from their highest conviction holdings.

More concentrated funds also increase the quality threshold for portfolio inclusion. There is greater competition for fewer places, raising the bar for companies to enter the funds and meaning they then have to perform in line with our expectations to remain there. This is evidenced by the average upside for Global and Kon-Tiki's holdings remaining constant as they have slimmed down, despite their value growing 17% and 10%, respectively, over this time(6). The holdings' quality has also been seen in recent company reporting with the majority delivering earnings growth and results ahead of expectations.

Reduced risk

While more concentrated portfolios may exhibit short-term volatility, as long-term investors we believe that carefully selecting the best valued companies should better protect the portfolios from negative business cycles and therefore bolster the funds' long-run down-side protection. It is easier to monitor fewer holdings – a benefit for clients as well as the portfolio teams – and decision-making is faster. A smaller number of less liquid holdings in the tail of a fund also increases its overall liquidity, which helps manage risk and is useful in times of market instability. The VIX index of equity volatility recently spiked during the war of words between the US and North Korea and stock markets may well experience further turbulence as monetary policy normalises.

While greater concentration doesn't automatically reduce turnover, a portfolio with fewer holdings will often reduce trading costs. Although they have fallen over the last few years and our funds typically hold their stocks much longer than most, this can make a meaningful difference to clients' returns, particularly when investing in emerging markets where costs tend to be higher.

Conviction and diversification

lthough the benefits of holding fewer companies are straightforward, opinion is divided on the ideal number of holdings to maximise a portfolio's risk-adjusted returns. The optimal number will depend on many factors and is unlikely to remain fixed, depending on market and portfolio factors at the time. Similarly, the higher volatility often associated with concentrated portfolios can be controlled if they are constructed with a sound investment philosophy and process that balances conviction and sensible diversification

Both SKAGEN Global and SKAGEN Kon-Tiki enjoy broad mandates and a large investable universe from which the portfolio managers select the best ideas based on their understanding of a company's mispricing and conviction that it will be corrected over time. By selecting the strongest and most undervalued companies, the funds and our investors will have the best chance to beat the market, particularly in their newly slimmed down form.

(1) Total EUR return of 186% from 25/11/08 – 31/07/17
(2) Active Share and Mutual Fund Performance; Petajisto; 2013
(3) Best Ideas; Cohen, Polk and Sill; 2010
(4) Fund Managers Who Take Big Bets: Skilled or Overconfident; Baks, Buse and Green; 2006
(5) Performance figures as at 31 July 2017 (Unilever NV +26%, SEC Preferred +35%, Naspers +44%)
(6) 31/07/14 – 31/07/17 total return in EUR, net of fees

Unless otherwise stated, performance data relates to class A units and is net of fees. Except otherwise stated, the source of all information is SKAGEN AS.

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