

PUBLIC EQUITIES: DIVERSIFICATION 2.0

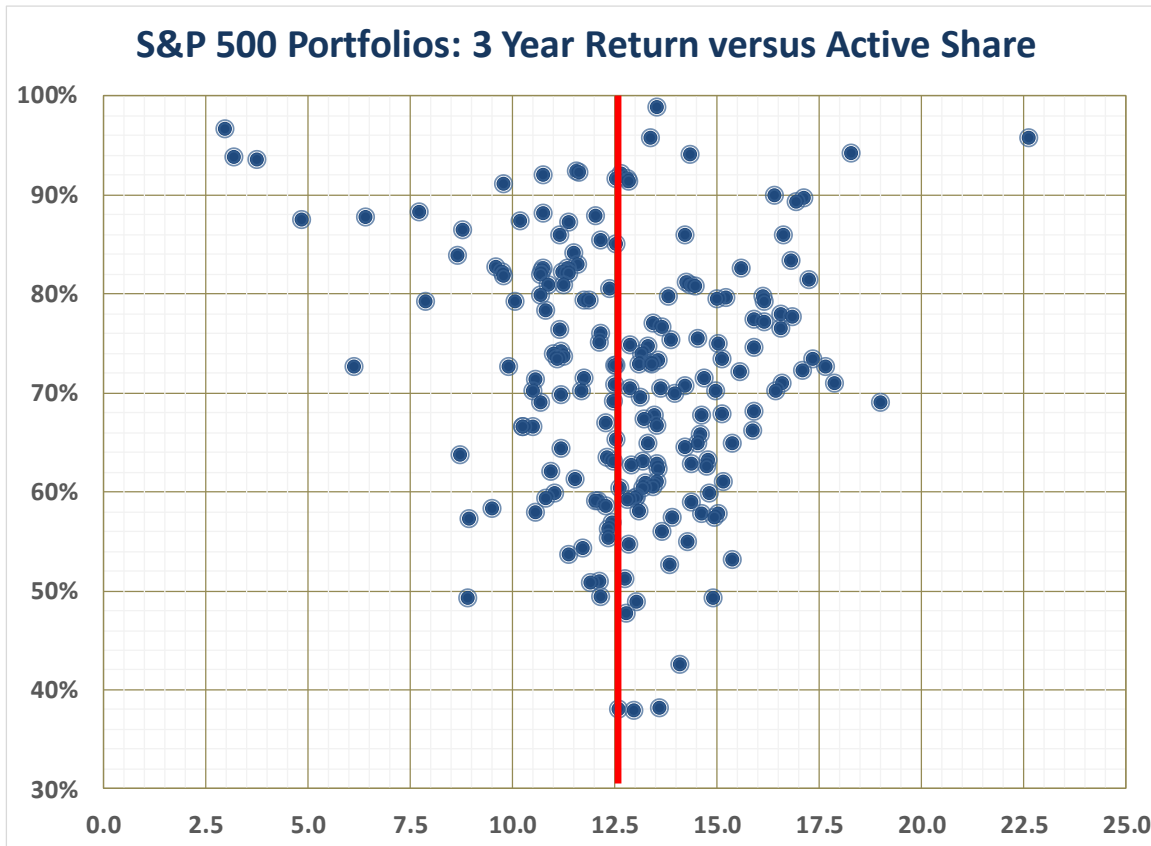
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DuPONT
CAPITAL

WHY TALK ABOUT DIVERSIFICATION ?

Is diversification still one of the last free lunches in capital markets?



- ❖ High conviction strategies can simply become high vol strategies without risk insights.
- ❖ Understanding the underlying risks increases conviction in the long term sustainability of the Alpha.
- ❖ But the way to achieve more effective diversification has changed.

X-Axis: 3 YR annualized performance, Y-Axis: Active share
Portfolios Benchmarked against the S&P500 (core) with AUM over 100 million and Active Share over 30%
Data as of 09/30/2019
Source: eVestment, DCM

- ❖ Diversification and Risk
 - ❖ Avoiding risk: the traditional way of diversifying
 - ❖ Embracing risk: a different way of diversifying
 - ❖ Conclusion

DIVERSIFICATION IS ABOUT MANAGING RISKS

We diversify to mitigate risks

In Real Life

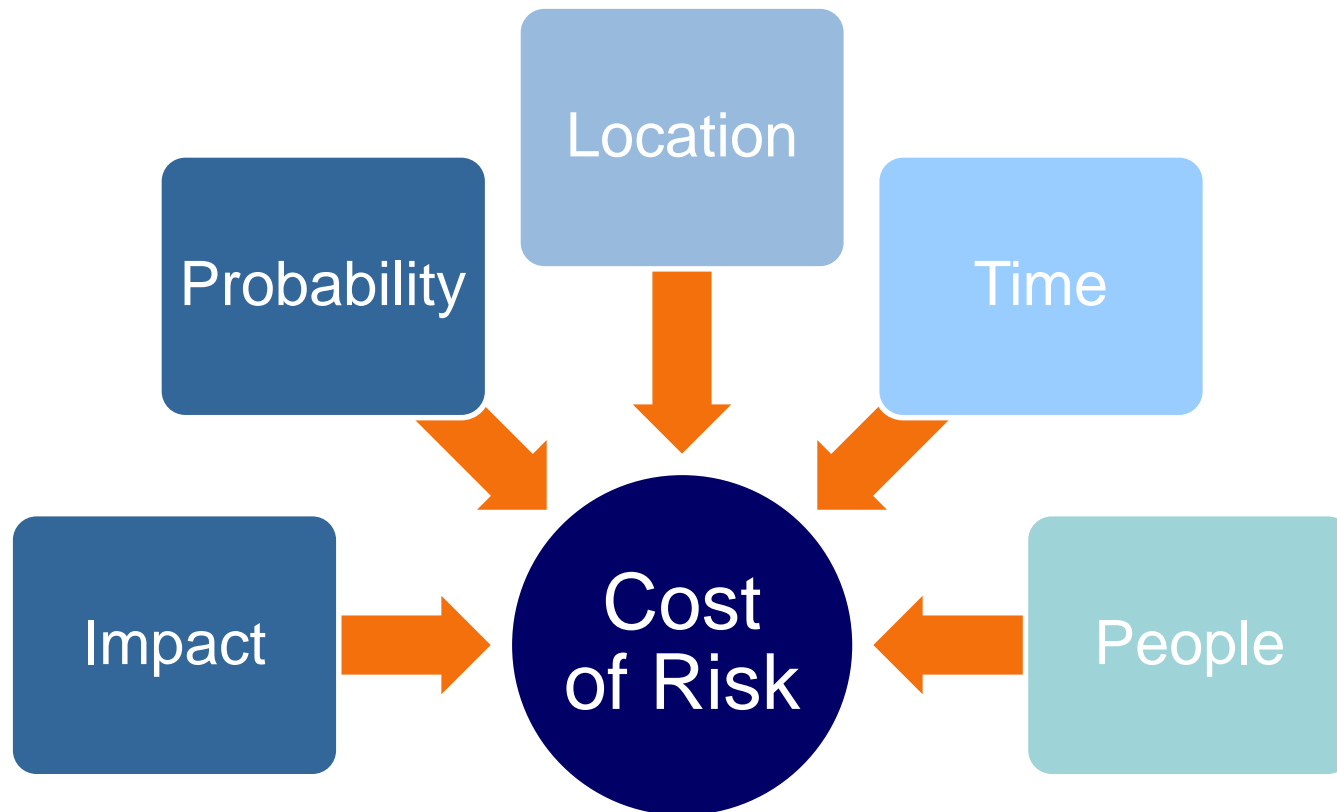
- ❖ Life Insurance
- ❖ Health Insurance
- ❖ Home
- ❖ Car
- ❖ Travel
- ❖ Back Up Generator
- ❖ AAA
- ❖ Product Warranties
- ❖

In Equity Markets

- ❖ Systemic Risks
- ❖ Geo-Political Risk
- ❖ Interest Rate Risk
- ❖ Volatility
- ❖ Country & Currency
- ❖ Sectors & Industries
- ❖ Company
- ❖ ...

DIVERSIFICATION AND RISK MANAGEMENT

Similarities and Differences between Insurance and Public Equities



THE OBJECTIVE OF PORTFOLIO CONSTRAINTS

Are traditional portfolio constraints adequately capturing risk characteristics?

Types of Risk

- Systemic
- Geopolitical
- Country
- Currency
- Volatility
- Style
- Sector
- Company
-

Portfolio Construction

- Tracking Error
- Country
- Sector
- Stock
- Style Exposures
- ...

Risk Characteristics

- Cost
- Impact

- Probability
- Location
- Time
- ...

DISCUSSION TOPICS

- ❖ Diversification and Risk
- ❖ **Avoiding risk: the traditional way of diversifying**
- ❖ Embracing risk: a different way of diversifying
- ❖ Conclusion

USING DIFFERENT RISK MODELS IS LIKE HAVING DIFFERENT CLOCKS

The utility is in the composition and relative ranking of the risks

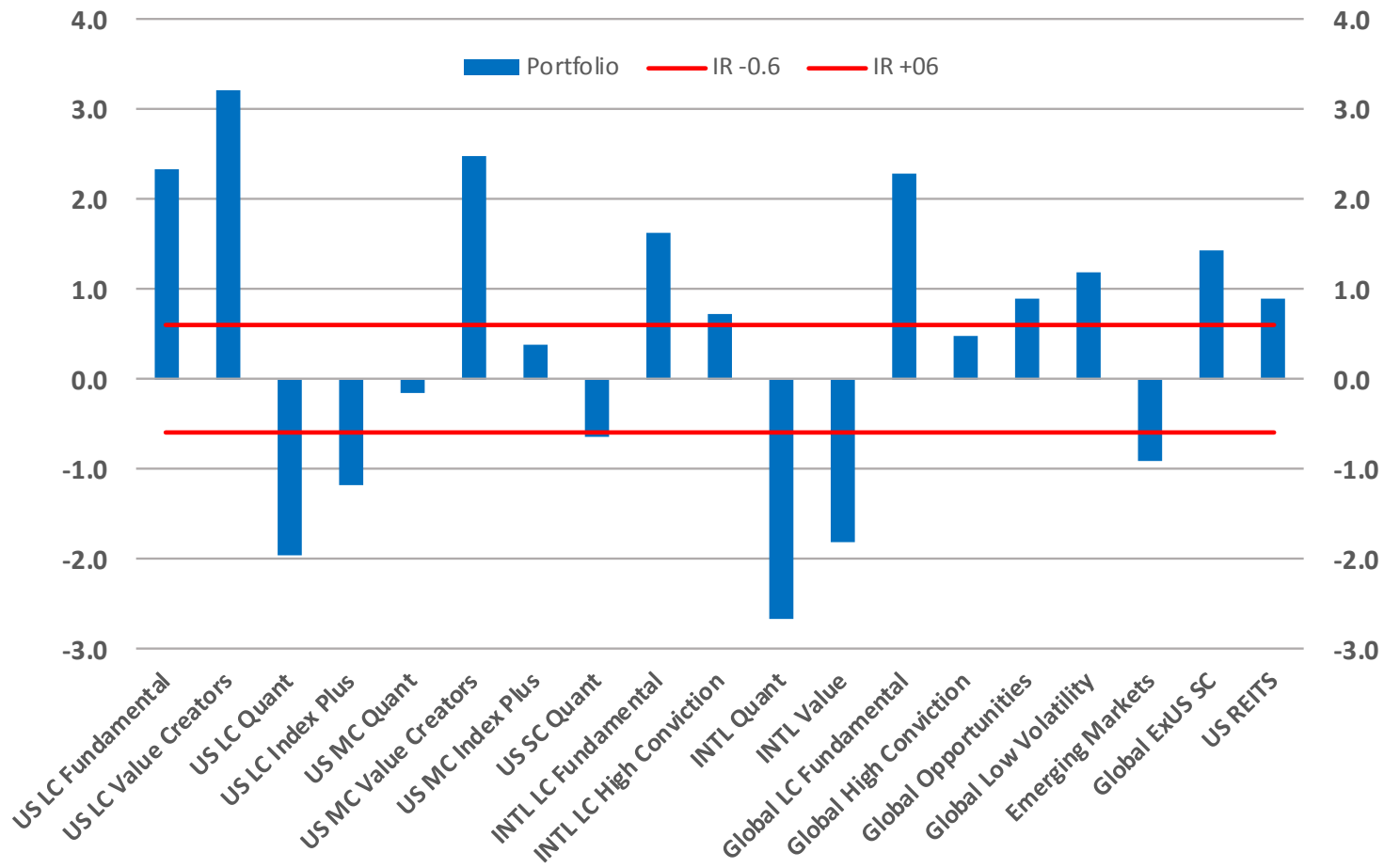


	Risk Models	
International Portfolio	Barra	Citigroup
Tracking Error	1.68	1.71
Market Sensitivity	1.01	1.00
Risk Decomposition (%)		
Macro Factors		22.7
Style Factors	11.9	
Sector / Industry	2.6	2.2
Country	15.1	4.2
Currency	5.8	
Risk Interaction	2.1	-9.5
Stock Specific	66.1	80.5

HAVE RISK MODELS TAKEN A YEAR OFF?

Information Ratios have Bifurcated

IR Range of Portfolios

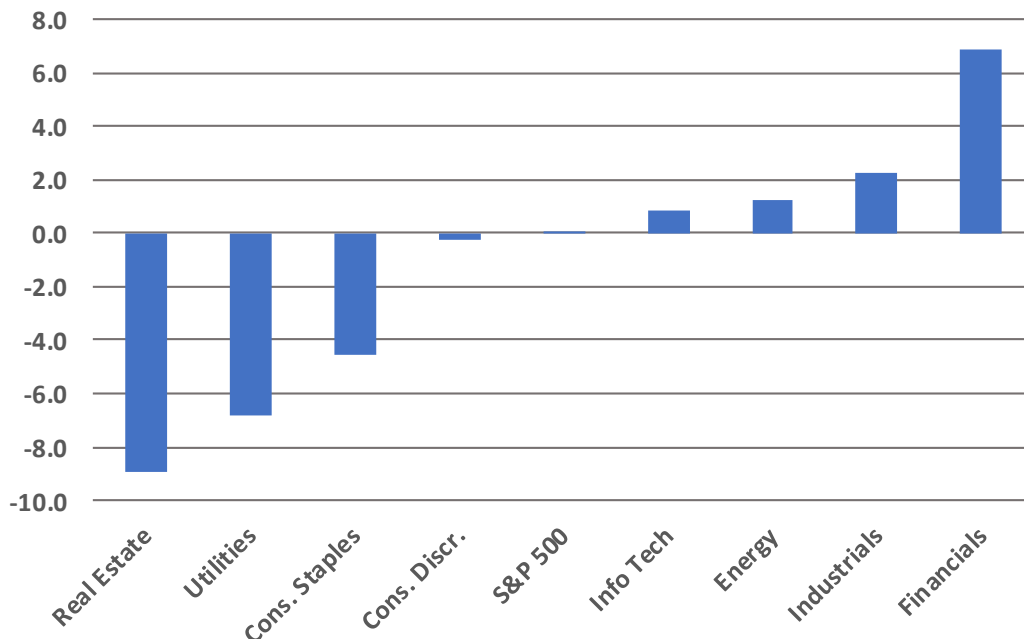


Sample of Theoretical Style Portfolios
 IR for 2019 Calculated as YTD return to 10/31/2019 divided by Barra ex ante TE as of 10/31/2019
 Source: Barra, FactSet, MSCI, DCM

TOP DOWN OR BOTTOM UP?

Understanding the interaction and correlation between risks

Median Long Interest Rate Sensitivity



- ❖ Most models and portfolio managers look at risk from a top down perspective.
- ❖ Risk is mostly managed one dimension at a time.
- ❖ Interaction and correlation between risks is often misunderstood
- ❖ Company characteristics and Sub-industry drivers have become much more important.

THE COST OF OVER-DIVERSIFICATION

A case for bottom up portfolio construction

- ❖ Potential to capture multiple risk dimensions
- ❖ Avoiding transaction and holding costs
- ❖ Avoiding “Dead Wood” or unproductive positions in the portfolio
- ❖ Possibility to increase the active share in the portfolio without unduly increasing the risk.



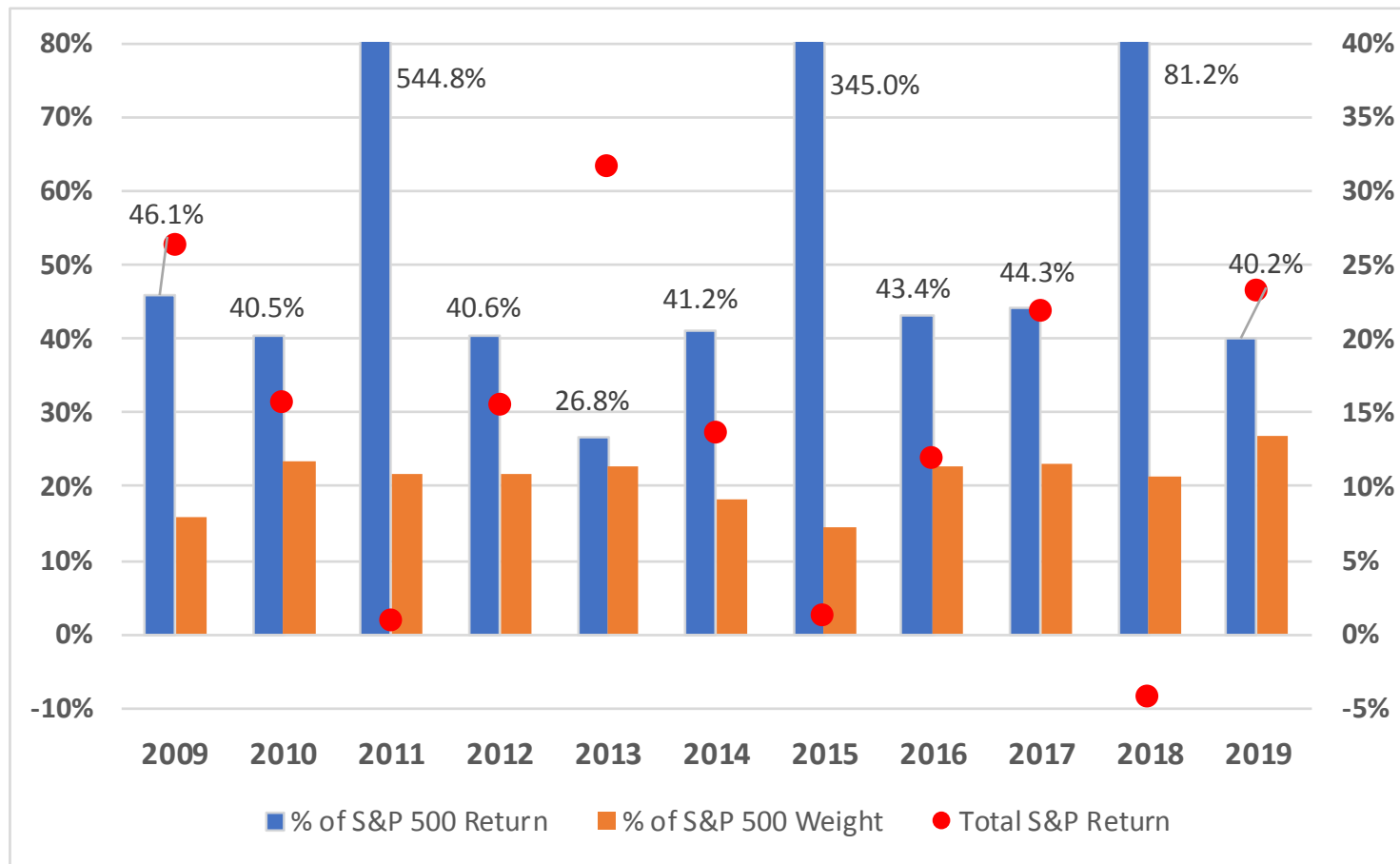
DISCUSSION TOPICS

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THE NEED FOR SOME LEVEL OF CONCENTRATION

Returns are not evenly distributed

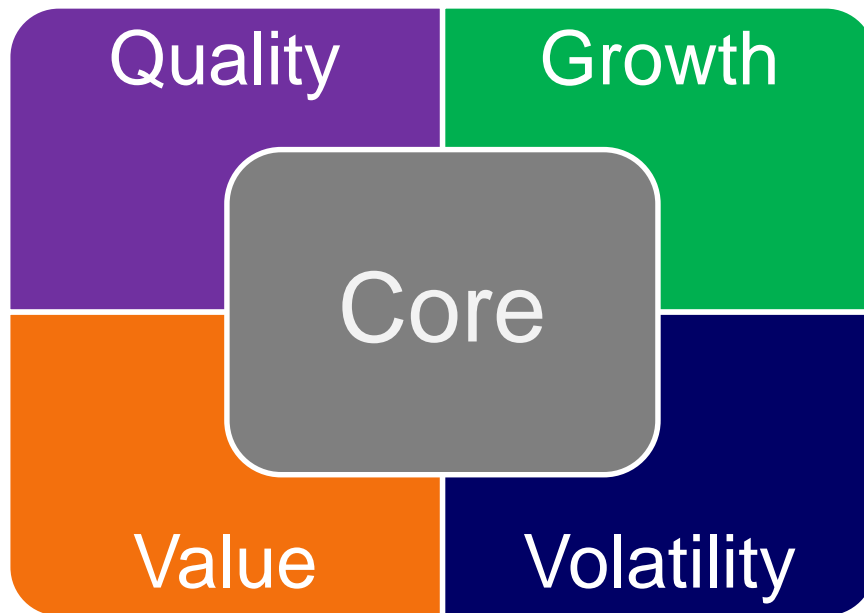
S&P 500 Top 20 Contributors



Return and Weight Contributions on Left Hand Scale, S&P Return on Right Hand Scale
 From 12/31/2008 to 10/31/2019
 Source: S&P, FactSet, DCM

COMBINING HIGH CONVICTION PORTFOLIOS

Looking for a better overall risk reward

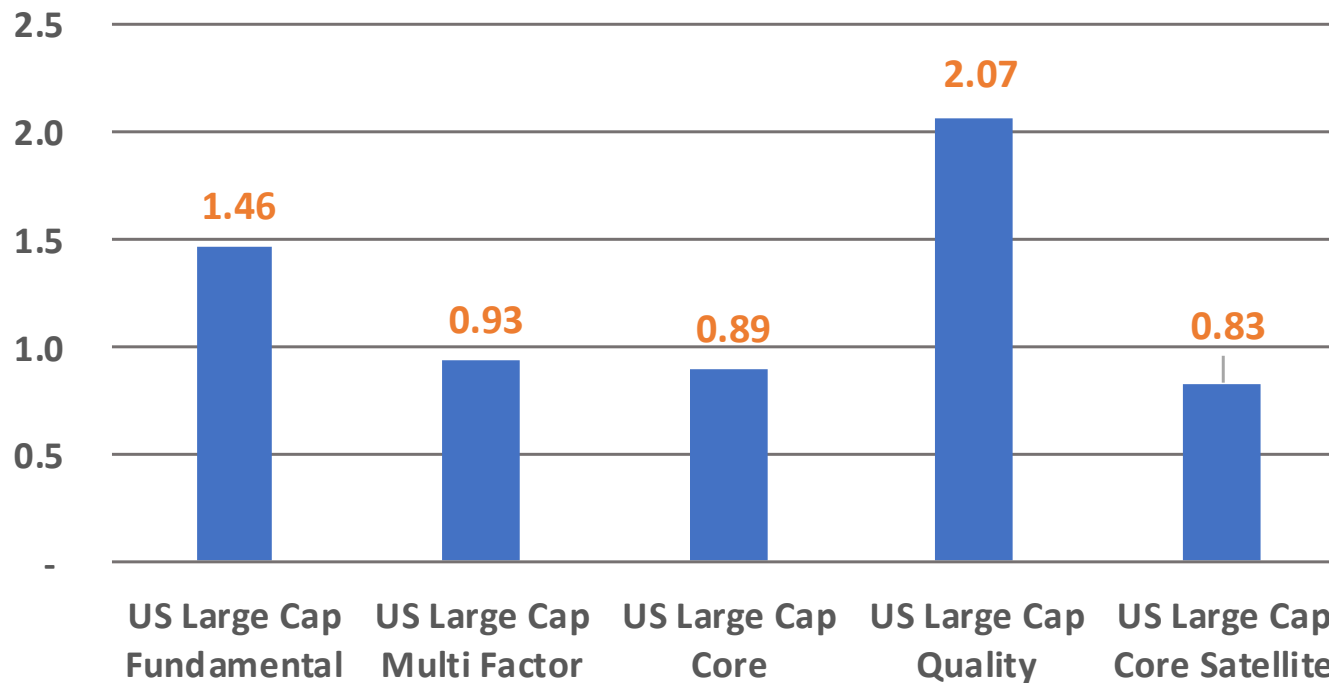


- ❖ Core portfolios under threat of ETF's and Passive.
- ❖ Avoid playing in the middle of the court.
- ❖ Bottom up alpha opportunities reside at all 4 corners of the perimeter.
- ❖ Uncovering these inefficiencies requires a long term horizon and a disciplined and consistent approach.

MORE EFFECTIVE DIVERSIFICATION

Adding Risk Can Lead to Better Risk Reward

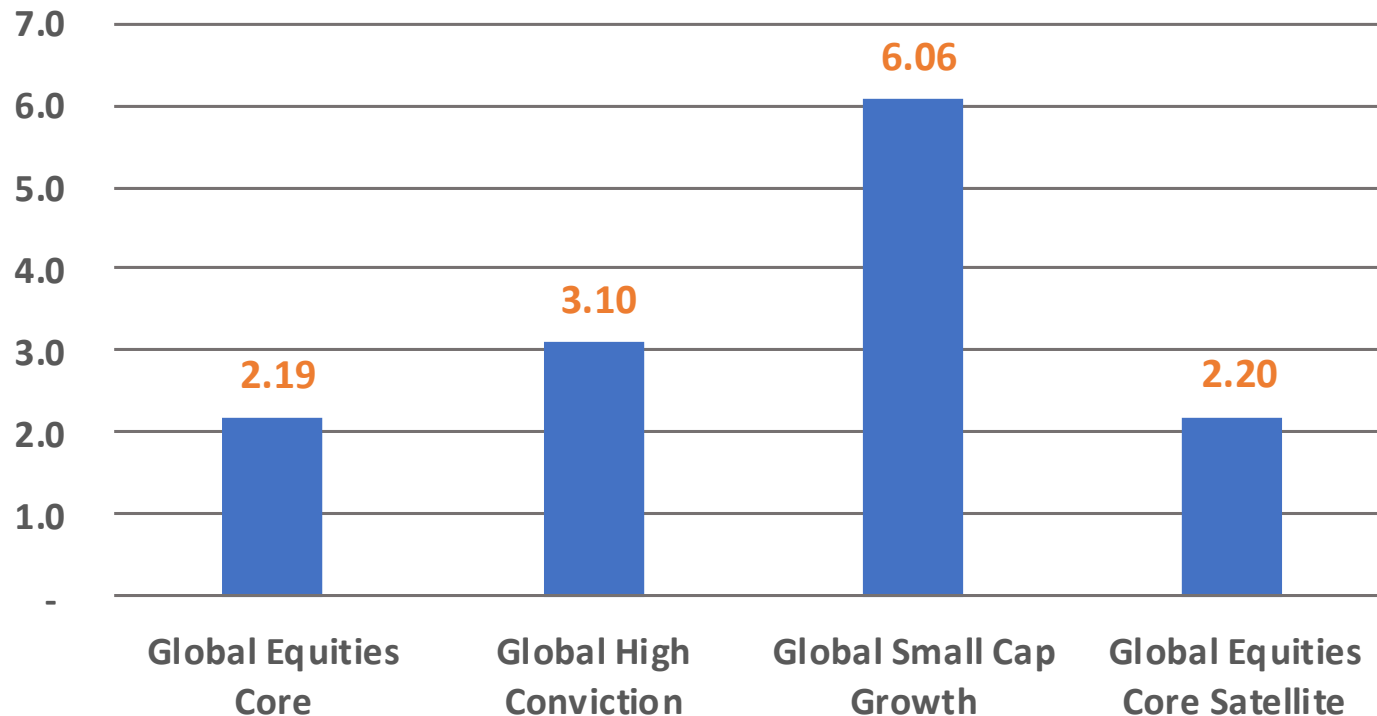
US Large Cap Equities: Core Satellite Risk Impact



MORE EFFECTIVE DIVERSIFICATION

Adding Risk Can Lead to Better Risk Reward

Global Equities: Core Satellite Risk Impact



COMBINING HIGH RISK PORTFOLIOS

	Tracking Error	
	with Satellites	w/o Satellites
US Large Cap Core	1.46	1.46
US Large Cap Quality	2.07	
US Large Cap Core Value	0.93	0.93
US Large Cap Composite	0.83	0.89
US Mid Cap Core Value	1.88	1.88
US Mid Cap Quality	2.99	
US Mid Cap Composite	1.74	1.88
US Small Core Value	2.24	2.24
International Core	1.94	1.94
International GARP	3.26	
International Index Plus	0.56	
International Value	2.40	
International Equities	1.65	1.94
Global Equities Core	2.19	2.19
Global High Conviction	3.10	
Global Small Cap Growth	6.06	
Global Equities	2.20	2.19
Global Small Cap	2.74	2.74
Aggregate Portfolio	1.01	1.15

DISCUSSION TOPICS

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CONCLUSION

More Effective Diversification = Better Risk Reward



- ❖ We see many Equity Portfolios that either over-diversify or under-manage risk.
- ❖ Are structural changes impacting the effectiveness of old risk models?
- ❖ Taking Risk in Public Equities is a good thing if managed appropriately.
- ❖ Combining High Conviction Strategies may provide a better risk reward over time than large integrated portfolios.

Above all, avoid playing in the middle of the court

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