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Does diversification still make sense for Japanese equity fund managers?

The imperative of long-term concentrated investment in pursuit of absolute returns

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Pension fund management has undergone various changes in response to the financial crisis that ensued from Lehman Brothers' 2008 collapse. For example, pension funds have been rethinking policy portfolios' role in pension asset management or adopting more dynamic approaches to risk management, such as tactically adjusting asset allocations in response to changes in the environment. A typical case in point is the Danish public pension fund ATP, which has partitioned its asset portfolio into two buckets: liability-matched assets and assets invested in the aim of boosting returns. ATP dynamically adjusts its asset allocation based on the size of its pension funding surplus.

Pension fund management is changing in Japan also. One major challenge facing Japanese pension fund managers is domestic economic stagnation. Poor economic performance has resulted in persistently low returns from Japanese equities, which typically account for a 20–30% allocation in pension fund portfolios. Japanese equities' chronic underperformance of equity markets elsewhere in the world is a major reason that Japanese pension fund returns have lagged behind recovery in global pension fund returns.

On the micro level, many Japanese companies are earning hefty profit margins by virtue of expansion into emerging markets in Asia and elsewhere. From the standpoint of publicly traded Japanese companies in aggregate, however, equity returns show little sign of improvement. Japanese equity price appreciation is a crucial issue for pension funds.

In this paper, I argue that to counteract the Japanese equity market's poor performance, pension funds must embrace a revolutionary concept of active management in the form of long-term concentrated investment. I also explain that such a revolution will require a new mentality among not only asset managers but also their pension fund clients.

Must active managers be benchmarked against an index reflective of the entire Japanese economy?

In not only Japan but globally, portfolio managers that actively manage assets on behalf of pension funds and other institutional investors are typically benchmarked against an index such as the TOPIX. Benchmarked portfolio management initially took root in the 1970s, mainly in the US. Today, asset management without reference to a benchmark is virtually unthinkable. From a pension fund's standpoint, benchmarks are generally expedient. Pension funds can select a benchmark for every asset class and evaluate investment performance against their chosen benchmarks. Benchmarks also help pension funds screen asset managers and investment strategies by gauging factors such as markets' investment appeal and efficiency, and managers' portfolio management skills.

On the downside, benchmarks' excessive prevalence has a number of drawbacks. First, because asset managers are evaluated based on excess returns relative to a benchmark, they tend to construct portfolios that largely replicate their benchmarks. They resort to such "closet indexing" out of fear of having mandates revoked by clients if they substantially underperform their benchmark as a result of unsuccessfully taking risks. Pension funds do indeed have a strong tendency to automatically pull assets from asset managers that have failed to deliver satisfactory performance for several years. This tendency is another factor conducive to closet indexing by active managers. Many equity fund managers consequently invest in diversified portfolios of over 100 stocks without concentrated exposure to any of them. Equity portfolio managers also tend to be overly conscious of their benchmark and limit their investment universe to their benchmark index's constituent stocks. Additionally, they often neglect to pursue absolute returns due to a fixation on relative returns even though their clients ultimately need absolute returns, not merely relative returns.

These problems have come to light in the wake of the Japanese equity market's dismal overall performance over the past two decades. Looking ahead, Japan is expected to experience slower economic growth than other regions. The equity market, which constitutes one component of economic growth, cannot feasibly deliver returns much in excess of the GDP growth rate over the long term. It is therefore reasonable to expect Japanese equities' beta (market rate of return) to remain depressed over the long term, absent a major increase in price/earnings (P/E) ratios and upward revision of investor expectations vis-à-vis equities.

In short, active management overly focused on a broad-market benchmark such as the TOPIX no longer makes much sense in the Japanese equity market. Not even the most skilled portfolio managers will be able to consistently earn excess returns of more than a few percentage points over the market's meager beta. Such performance will not suffice in absolute terms. Pension fund managers should reassess whether benchmark-focused active management fulfills their fiduciary responsibilities.

Deviating from broad-market benchmarks is essential

Instead of benchmark-focused active management of Japanese equities, pension funds need to pursue absolute returns by increasing portfolio concentration and deemphasizing benchmarking against a broad-market index. Paradoxically, such a benchmark-indifferent investment style's ultimate objective is high excess returns (alpha) relative to broad-market benchmarks. Additionally, this approach is predicated on long-term investment because it often fails to outperform in short timeframes (for reasons explained below).

The rationale behind concentrated investment is that, without it, returns are very likely to end up closely tracking the benchmark. I will illustrate this point with a simplified example in which an equal-weighted portfolio is used as a benchmark. Assume that a portfolio manager invests in an equal-weighted portfolio of n stocks selected from an investment universe of N stocks. If N is a sufficiently large number (i.e., $N > 2{,}000$) and the manager is benchmarked against an equal-weighted portfolio of the N stocks, an equal-weighted n-stock portfolio's deviation (σ_n) from the benchmark return can be expressed by the formula below without reference to N. In the formula, σ represents the dispersion (volatility) of the N stocks' individual returns at a given point in time.

$$\sigma_n \cong \frac{\sigma}{\sqrt{n}}$$

This formula means that as the number of stocks held (n) increases, tracking error (i.e., returns' deviation from the benchmark) progressively decreases as a function of the square root of n.

As a simple example, assume a cross-sectional volatility (σ) of 30% (= annualized cross-sectional dispersion of Tokyo Stock Exchange 1st Section-listed stocks' monthly returns since 2005). When this assumed volatility is plugged into the formula above, the expected tracking error of an equal-weighted portfolio of 100 stocks would be 3 percentage points (ppt) (one-tenth of the individual stocks' 30% cross-sectional volatility). Regardless of how good a stock picker the portfolio manager is, the portfolio's returns will on average be within ±3ppt of the benchmark return two-thirds of the time.

In this case, to increase the tracking error to 10ppt or above, the number of stocks held in the portfolio must be limited a maximum of nine (the square root of which is three: 30% ÷ 3 = 10% per the formula above). In fact, a tracking error of 10ppt or above probably could be achieved with a portfolio of somewhat more than nine stocks, given that the deviation in returns between a market-capitalization-weighted benchmark and an equal-weighted benchmark is around 10ppt on average. In any case, a highly concentrated portfolio is required to overcome the gravitational pull of low beta.

A pension fund must earn absolute returns at least equal to the return promised to its beneficiaries. Pension funds cannot fulfill their fiduciary responsibilities by outperforming a benchmark prone toward low absolute returns. The investment style needed for Japanese equities is a benchmark-indifferent approach capable of delivering high absolute returns and, ultimately, high alpha.

Such an investment style may not be necessary in countries with favorable medium- to long-term prospects of robust economic growth, such as China or India. In Japan, however, and other countries with relatively low economic growth rates, a beta-indifferent investment style is essential.

Given the high degree of portfolio concentration that such an investment style entails, short-term returns can be highly volatile. With returns thus susceptible to substantial downside volatility in short timeframes, pension funds that outsource portfolio management to external fund managers must have the patience to evaluate investment performance on a long-term horizon, as explained below.

Skills required to generate absolute returns and two approaches to doing so

What skills are required to generate absolute returns in the Japanese equity market? Some readers might think of long-short strategies common among hedge funds, but this type of strategy is highly likely to be a zero-sum game. Long-short strategies are not an appropriate investment model for pension and other funds that manage huge pools of assets on behalf of others. What is required is back-to-basics, long-only investment with a high degree of portfolio concentration.

While the Japanese equity market's overall growth prospects are limited as mentioned above, many individual companies are highly profitable. Japanese companies are still globally renowned for their elemental manufacturing technologies and high-quality services. Fund managers have ample potential to deliver high returns to clients through bottom-up stock picking.

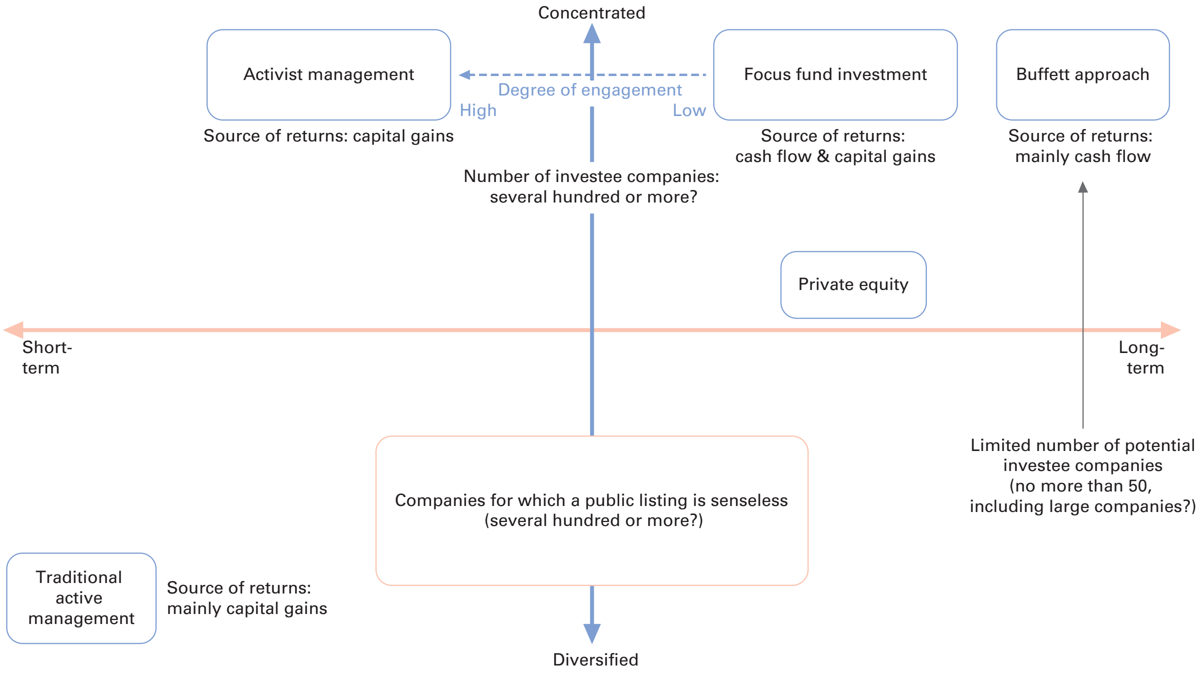
1) Two approaches

Two approaches to concentrated investing come to mind. The first is a long-term buy-and-hold strategy à la the legendary US investor Warren Buffett. The second is active engagement (activism). The differences between the two approaches are summarized in the diagram below.

(1) Buffet approach

The Buffet approach aims to capture high absolute returns

Exhibit . Classification of active management styles



Source: NRI

by identifying companies that are undervalued but have the capacity to generate hefty future cash flows, selecting investee companies based on additional criteria such as the quality of their management and their industries' competitive landscape, and buying their shares for a long-term holding period. The source of investment returns is the cash flows that the investee companies generate. The Buffet approach differs markedly from the pursuit of capital gains from short-term trading. Its potential investment universe is not limited to small-cap stocks; even large-cap companies sometimes meet its investment criteria.

From conversations with several major Japanese asset management companies, I learned that some are already implementing the Buffet approach. One firm told me that despite the Buffet approach's high degree of portfolio concentration, its portfolio's volatility is lower than benchmark volatility because most of the stocks in the portfolio have strong downside price support.

One drawback of Buffet approach is that companies that meet its investment criteria are typically few in number. The subset of companies that meet the investment criteria of a bargain valuation and high degree of cash-flow generative capacity is distinguished by a tendency to shrink in size and lose bargain appeal as Buffet-approach practitioners increase in number. Some estimate that even today there are no more than some 50 publicly traded Japanese companies that meet the Buffet approach's investment criteria.

(2) Active engagement
Active engagement differs from the Buffet approach in that it focuses not on existing cash-flow generative capacity but on latent potential to generate future cash flows.

Specifically, it targets companies that are unable to generate high cash flows with their existing modus operandi but have the potential to increase that cash flow. Investors that practice active engagement invest in such companies and advise their management on how to realize this potential.

Compared to the Buffet approach, active engagement has the advantage of a considerably larger pool of potential investee companies. One reason that the Japanese equity market is mired in the doldrums is that many companies are not living up to their profitability potential. Many companies could boost their profitability by improving their management.

One impediment to active engagement is that few equity fund managers are capable of offering CEOs advice that will improve the company's earnings. To give earnings-enhancing advice, an adviser must be knowledgeable about not only finance but also the advisee company's industry. Active engagement requires its practitioners to propose ideas that will increase earnings in the real world, but the ability to do so is far removed from the typical asset manager's skill set and work experience. While the requisite turnaround-advisory skills are rare in the asset management industry, they can sometimes be found in industry at large. For example, Japanese general trading companies appear to potentially possess such turnaround skills, judging from their activities in recent years. The asset management industry could attempt to tap into these skills as one possible approach.

Even if asset managers did possess the requisite skills, some observers question whether they can effectively advise the management of publicly traded corporations as outsiders without inside information. Rather than financial skills, what active engagement requires are industry skills that improve a target company's operations from the inside. Such skills essentially coincide with those possessed by private equity managers. This coincidence raises concern about whether it is possible to radically improve a company's operations without taking the company private, becoming an insider, and utilizing up-to-date inside information. On the other hand, some hedge funds have achieved success as activist investors by making operational improvement recommendations to publicly traded companies. These success stories support the view that companies can indeed be turned around through active engagement without being taken private.

2) Advantages of concentrated investment
If a fund increases its portfolio concentration, its investee companies' individual impact on its returns likewise increases. Consequently, fund managers' interest in their investee companies' management and businesses should naturally increase as an incidental effect of increased portfolio concentration. Amid the recent financial crisis, institutional investors in the UK were criticized for

irresponsibly overlooking financial institutions' deficient governance due to inadequate due diligence. This failure was attributed to the fact that they held diversified portfolios with small portfolio allocations per investee company. Increased portfolio concentration should motivate fund managers to monitor investee companies more closely. It is also conducive to stricter management discipline than in the past.

Additionally, practitioners of active engagement generally have a strong tendency to be long-term holders of the stocks in which they invest. Active engagement can accordingly reduce portfolio turnover and, in turn, transaction costs. It can be a particularly effective investment approach for pension funds, which are by definition long-term investors.

By pursuing absolute returns unfettered by benchmarks, fund managers can intensively invest in companies that they expect to truly generate high cash flows in the future, enabling them to support Japanese economic growth by funding companies with favorable growth prospects through efficient allocation of capital, one of an asset manager's intrinsic functions. Some critics contend that this function no longer exists amid the popularity of benchmark-focused asset management in pursuit of relative performance. Fulfilling such fundamental functions of active management is another respect in which concentrated investment is important.

Pension fund (client) cooperation is essential

Is the feasibility of such concentrated investment approaches determined solely by the asset manager's skill? Many pension fund executives probably think so, but the late Peter Bernstein, a renowned asset management scholar, did not.

Bernstein wrote, "I am convinced that alpha is a joint product of the manager plus the client (e.g., pension funds)., not just the manager alone." In other words, unconventional investment approaches that capture a high degree of alpha require the cooperation of clients, who must possess certain attributes.

What is the defining attribute of clients capable of supporting such unconventional investment approaches? In Bernstein's words, clients must have "the courage to be wrong and alone". Clients must have the courage to hire fund managers with vastly different investment styles than other managers and to accept that such managers will sometimes underperform their benchmarks by a wide margin.

The importance and difficulty of having such courage is well illustrated by the example of David Swensen, Yale University's Chief Investment Officer. None of the asset managers hired by Yale to manage its US equity allocation is a major, well-known asset management firm. Instead, they are all small firms that employ concentrated investment strategies (e.g., limited to a specific sector). One of these managers reportedly has at times held as few as three stocks in its portfolio.

Yale hires such managers because Swensen believes that if you want to outperform your benchmark in the highly efficient US equity market, your portfolio composition must differ substantially from the benchmark. With a highly concentrated portfolio, returns are more prone to deviate substantially from the benchmark to the upside or downside. In 1995–98, Yale University's US equity portfolio underperformed its benchmark by an annualized 4.3ppt (its underperformance troughed at an annualized -4.7ppt as of end-January 1999). Nonetheless, Yale continued to renew its US equity fund managers' mandates instead of firing them. As a result, Yale's US equity portfolio ended up outperforming its benchmark by an annualized 11.2ppt over the eight years through 2002.

According to Peter Bernstein, "No manager can earn alpha without skill, but no manager can earn sustained and statistically significant alpha without clients who really can stand the heat in the oven or who sign on with some form of lock-up so that the funds are not like a bank deposit that can be withdrawn on demand. Like all great managers, Warren Buffett has had extended dry spells. What would his track record look like if he were not operating in an essentially closed-end fund environment?"

It bears noting that Yale University was able to adopt such an investment approach because it practiced cautious risk management, allocating only 20% of its total portfolio to US equities, thereby minimizing the impact on its overall portfolio of its US equity managers' underperformance. Another key point is that Swenson and his team were patient because they were intimately familiar with each equity manager's holdings and investment rationale. While Yale's US equity portfolio was ostensibly underperforming, Swenson had his own view of whether such underperformance was likely to continue or not.

As Peter Bernstein said, for a manager to generate alpha on a sustained basis, the client must have a deep understanding of the manager, a cautious risk management process, and a clear-cut governance structure that enables the portfolio management team to focus single-mindedly on execution of its strategy. To capture alpha, pension funds also must be willing to submit to stringent conditions.

Toward fresh growth in Japanese equity management

I am well aware that concentrated investment approaches are not easily implementable. The Buffett approach cannot be a universal solution, given the dearth of potential investee companies that meet its investment criteria. Meanwhile, active engagement faces a similar constraint in the form of a dearth of asset managers with the requisite skill set. Moreover, even if fund managers propose such concentrated investment approaches, bureaucratically managed pension funds are unlikely to adopt them because doing so would inevitably lead to highly volatile short-term returns and large deviations from other managers' returns.

Nonetheless, if such concentrated investment approaches grow in prevalence, return differentials between individual stocks may widen sharply as high-quality companies' stocks attract investment inflows while lower-quality companies see their share prices languish and come under pressure to delist their shares. Proper allocation of capital by active managers could paradoxically revitalize the equity market and, in turn, boost beta. Active managers' pursuit of high alpha should ultimately increase Japanese equities' beta.

The fastest way for concentrated investment approaches to gain prevalence is for them to give rise to many success stories. If a new breed of fund managers emerges to help enhance Japanese companies' value while achieving successful investment performance, their investment approaches should gain popularity as a result. Despite the difficulty of putting concentrated investment into practice, pension funds and asset managers should jointly embrace the realization that unless they cooperate with each other to cultivate concentrated investment approaches, thereby helping to revitalize Japanese companies, Japanese equities will never recover in earnest.

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