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Five principles for performance persistence

Setting out the approach of our Global Equity Endurance strategy

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Barney Goodchild
Head of Credit and Equity Investment Specialists

Main responsibilities

Barney leads the credit and equity investment specialists team. The team works closely with portfolio managers across our credit and equity platform to articulate their investment process, portfolio positioning and investment performance to clients and consultants around the world.

Francois de Bruin
Global Equity Fund Manager

Main responsibilities

Francois is co-manager of the Global Equity Endurance Fund and manager of the Stewardship International Equity Fund. He previously also managed sustainable income & growth and listed real estate portfolios.

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Portfolio Manager

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Richard is the lead fund manager for the Global Equity Income Fund and co-manager for the Global Equity Endurance Fund and the Social Transition Global Equity Fund.

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Five principles for performance persistence: Key takeaways

An overemphasis on capital protection can make hitting long-term performance targets challenging.

Performance persistence requires careful calibration of risk and reward, and avoidance of common pitfalls such as overdiversification and short-termism.

Finding productive companies and understanding durable competitive advantages and network effects, combined with valuation discipline, can help managers generate long-term outperformance on a persistent basis.

Introduction

A quick scan of marketing collateral for most investment products will generally point to a goal of outperforming a reference index with similar or lower levels of risk. However only a few global equity products have consistently delivered on the return side of the equation.

Certain strategies, such as those with a value or growth bias, can be expected to have a natural cyclicality to their returns. However, for funds marketed as having an all-weather approach (such as those included in the Morningstar Large Cap Blend peer group), investors would expect more consistency.

> For funds marketed as having an all-weather approach, investors would expect more consistency

Looking at rolling three-year excess returns for the peer group between 2017 and 2022, only 13 out of a total sample size of 110 funds consistently generated a positive excess return.[1]

So, why is consistent outperformance elusive for most managers? In this paper, we seek to answer this and explain how our Global Equity Endurance strategy seeks to retain its membership as part of the elite group of evergreen strategies delivering persistent outperformance, highlighting:

- Why investors should focus on both relative and absolute risk
- Why an overemphasis on diversification, "quality" and short-termism are pitfalls investors should avoid
- The five principles underpinning our approach

Redefining risk: Introducing rule number three

Warren Buffett famously stated his first two rules of investing are: "Rule number one: Never lose money. Rule number two: Never forget rule number one."

The simplicity underplays its significance. If a fund falls ten per cent, it needs to generate an 11 per cent return to get back to even. A 50 per cent fall needs a 100 per cent return to recover.

Like most good things in life, however, *good things* can become distorted when they become *ultimate things*. For downside protection is only one side of the equation. Over the long term, equity markets tend to move higher, meaning the number of positive observations outweigh the negatives. This asymmetry means active equity investors should add a third rule: grow your money.

> The industry has done a good job of protecting capital, but not kept pace with or outperformed benchmarks

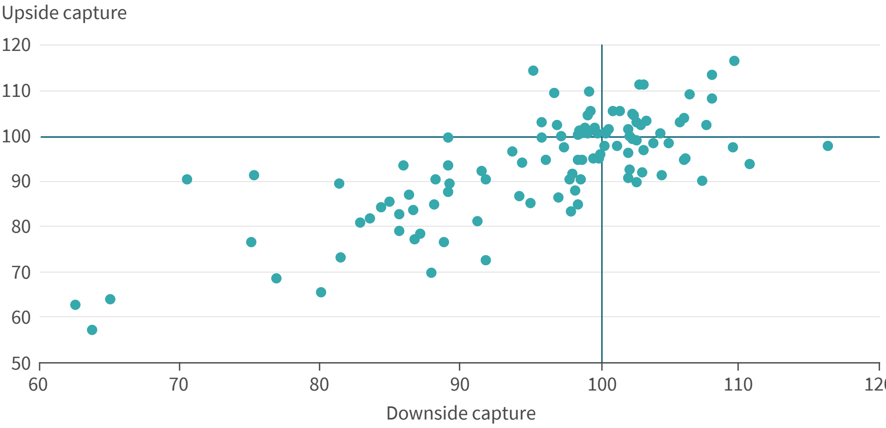
Stated differently, for active global equity managers, risk is both absolute and relative. Managers need to balance the risk of a permanent loss of capital (absolute) with not taking sufficient risk to achieve long-term performance targets (relative). Compared to other asset classes, this is perhaps even more pertinent given equity investors have the strongest mandate to grow capital over the long term.

Capture ratios[2] provide useful insight when seeking to understand whether fund managers have abided by these rules. This approach separates a historic return series into two buckets – months when the market went up and months when the market went down – and looks at how an investment performed in each. Taking the average of the two populations results in the investment's capture of the upside and downside; dividing one by the other gives the overall capture ratio.

Broadly speaking, the industry has done a good job of protecting capital, but this has come at the cost of keeping pace with or outperforming benchmarks. Figure 1 shows:

- 68 per cent of funds have a downside capture ratio of less than 100
- Only 38 per cent of funds have an upside capture of greater than 100

Figure 1. **Global equity strategies: Capture ratios versus benchmark**



Past performance is not a guide to future returns

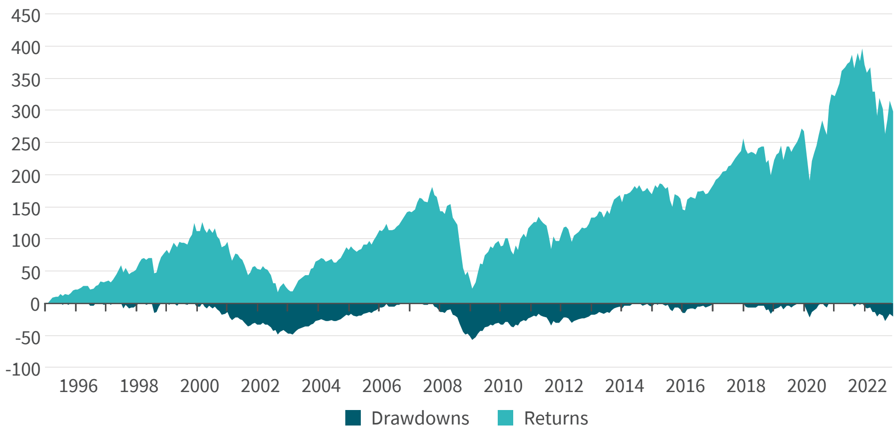
Note: Morningstar Large Cap Blend equity strategies benchmarked to either MSCI ACWI or MSCI World. Oldest share class capture ratio versus prospectus benchmark, December 31, 2017 to December 31, 2022.

Source: Aviva Investors, Morningstar. Data as of December 30, 2022.

The reality is that managers tend to fall into one of two camps: employing either an aggressive or defensive stance. Only a small proportion have been able to deliver both upside and downside protection.

But given that equity markets have tended to rise over the long run (as seen in Figure 2), an overemphasis on capital protection at the expense of returns can make hitting long-term performance targets challenging.

Figure 2. **Global equity index returns, 1994-2022 (per cent)**



Past performance is not a guide to future returns

Note: MSCI ACWI, 1994-2022.

Source: Aviva Investors, Bloomberg. Data as of December 30, 2022.

This begs two questions: Are many equity portfolio managers too cautious; and can we solve the problem by increasing risk? The answer to both is, "potentially"; but there are three main pitfalls investors need to overcome to build robust and outperforming portfolios.

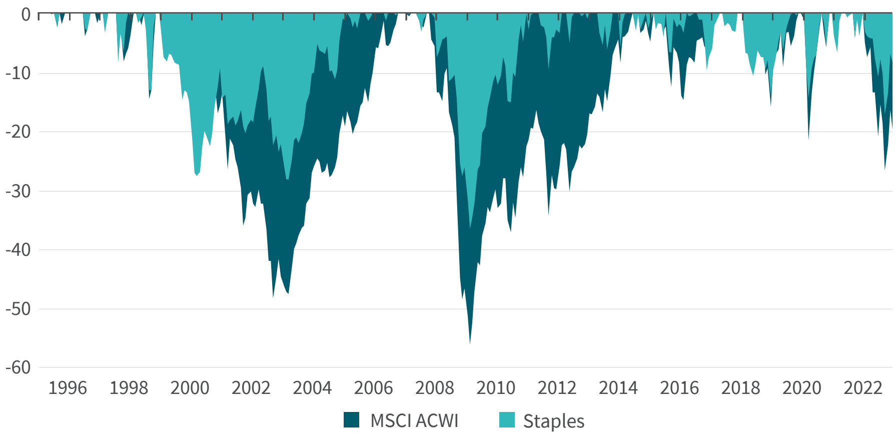
Seeing the trees and the forest: Common pitfalls

Pitfall 1: The problem with "quality"

In searching for stocks with defensive characteristics, investors are often drawn towards "quality" sectors, such as consumer staples. These are parts of the economy that often show resilience during a downturn because consumers continue to spend money on these products and services. As a result, companies in these sectors tend to retain their valuation multiples better than more growth-oriented industries such as information technology and life sciences.

Given that changes in multiples/valuations tend to drive short-term share price performance, quality sectors tend to hold up better in a downturn (Figure 3).

Figure 3. **Drawdowns for broad index versus consumer staples sector (per cent)**



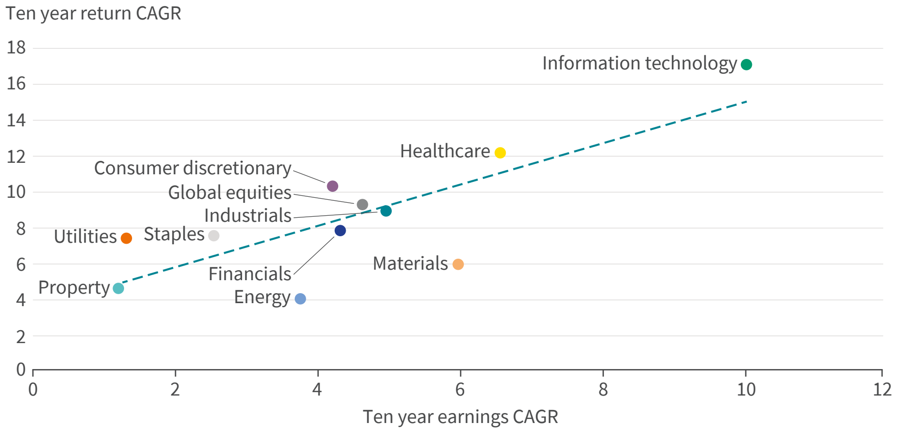
Past performance is not a guide to future returns

Note: MSCI ACWI index.

Source Aviva Investors. Data as of December 31, 2022.

However, long-term performance is driven by a company's ability to grow cashflows. More defensive or quality sectors tend not to provide the cashflow growth needed to generate long-term share price appreciation (Figure 4). Business duration needs to be weighed in conjunction with the propensity for cashflow growth.

Figure 4. **Correlation between long-term earnings growth and share price appreciation (per cent)**



Past performance is not a guide to future returns

Note: MSCI ACWI index.

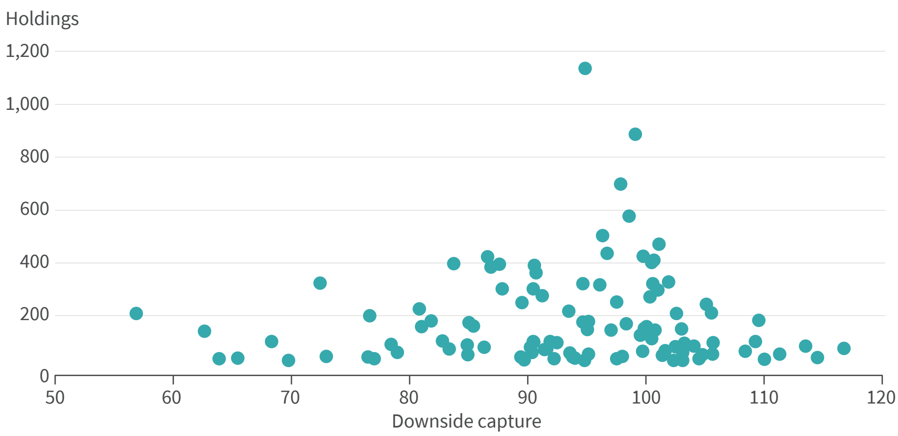
Source: Aviva Investors. Data as of September 30, 2022.

Pitfall 2: Diversification (why safety doesn't always come in numbers)

Investors often assume additional holdings will reduce stock-specific risk and improve diversification. The reality, based on data from our peer group, as illustrated in Figure 5, is that diversification benefits reduce after 20 holdings, with no clear improvement in downside capture from increasing them.

In our view, the most effective way to build protection into portfolios is through fundamental analysis and company selection rather than increasing holdings. Understanding how companies relate to one another and the economy are more important than adding to a list of securities in a portfolio, effectively engaging in what Warren Buffett refers to as "diworsification".

Figure 5. **Holdings versus downside capture**



Past performance is not a guide to future returns

Note: Morningstar Large Cap Blend equity strategies benchmarked to either MSCI ACWI or MSCI World.
Oldest share class downside capture ratio versus average holdings, December 31, 2017 to December 31, 2022.

Source: Aviva Investors, Morningstar. Data as of December 31, 2022.

Pitfall 3: Anchoring to expectations

In addition to balancing quality and growth, investors need to recalibrate their expectations.

Equity investors know it is not enough to identify good companies. They must also assess whether these expectations are appropriately reflected in share prices. Episodes such as the Nifty 50 boom and bust in the 1960s and 1970s serve as powerful reminders to do so.

Unfortunately, expectations management has spawned into an entirely different sport on its own. Investors become obsessed with earnings expectations and whether consensus expectations are too high or too low for any given quarter and miss the forest for the trees.

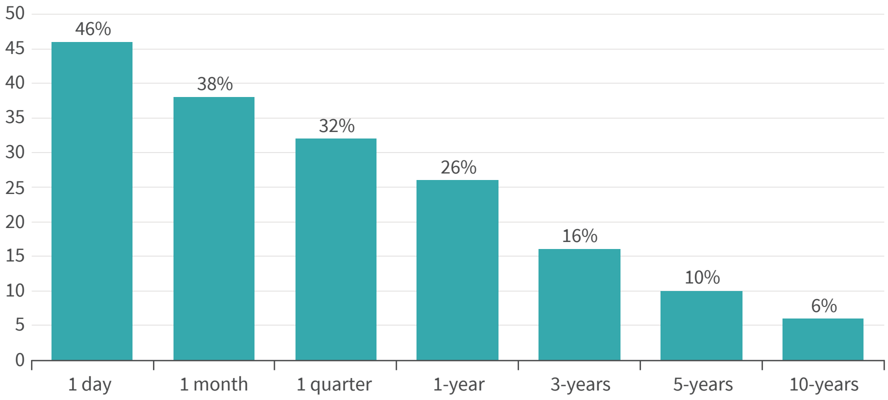
Investors become obsessed with earnings expectations and miss the forest from the trees

If a company has grown 15 per cent but the consensus forecast of analysts was 20 per cent, this is seen as a negative. In our view, investors should instead look at the absolute numbers relative to the price and whether this is consistent with their long-term expectations. Deviations from expectations have minimal impact on intrinsic value, despite an enormous amount of effort spent by speculators to profit from such activities.

While most investors would do well to ignore the barrage of noise coming from Wall Street and mainstream media, it is equally important to base their own long-term expectations in reality. Quality investors become overly reliant on their estimates of "intrinsic value", often to their own detriment. They fail to update their thinking when faced with new evidence, or anchor to unqualified (and unobservable) heuristics about the future. This fallibility is reflected in their assumptions and has a material impact on their forecasts, resulting in improper conviction.

The important thing to remember is as investment horizons extend, expected returns have a natural asymmetry. The probability of losses for the S&P 500, for example, is significantly reduced when measured in years as opposed to days and months. Fortunately, over rolling three-year periods, returns are over six times as likely to be positive than negative. Investors can make reasonable extrapolations about the future without having to turn to ultra-long term, and perhaps philosophical, assumptions to tilt the odds in their favour.

Figure 6. **Probability of negative returns for the S&P 500 (per cent)**



Note: January 1, 1929 to June 30, 2022.
Source: Aviva Investors, S&P, Bloomberg, BofA US Equity & Quant Strategy. Data as of June 30, 2022.

With that in mind, here are the key elements that underpin the approach of our Global Equity Endurance strategy, which aims to deliver a portfolio with less cyclicality and higher predictability, alongside downside protection.

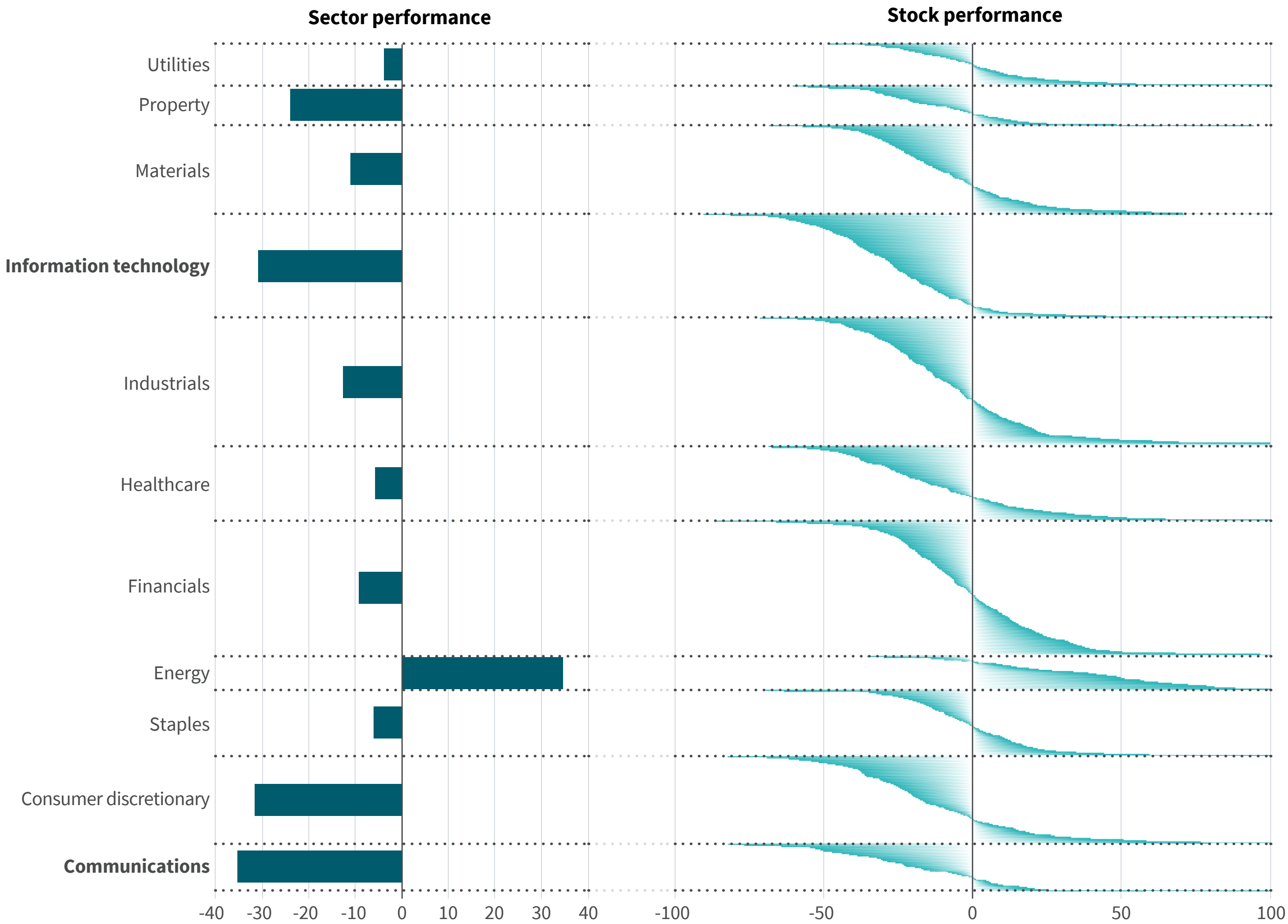
Our five golden principles for performance persistence

Principle 1: Focus on companies, not sectors

Stereotypes are not helpful whether they apply to people or companies. A natural consequence of trying to group businesses by sector is that some will have characteristics or business lines that cover more than one sector. For example, Mastercard and Zoom are both considered technology companies but have entirely different business models and fundamental drivers.

Recent performance helps illustrate this (Figure 7). The two sectors that struggled most in 2022 were tech and comms services; however, when we look beneath the surface at individual company returns, there has been significant divergence.

Figure 7. **MSCI ACWI returns in 2022 (per cent)**



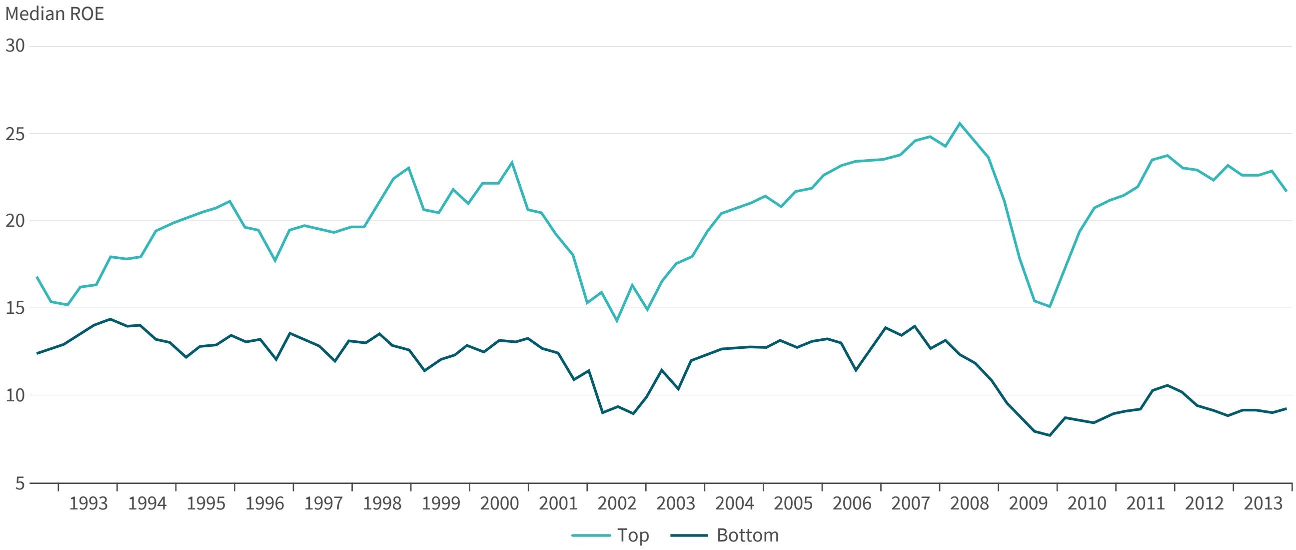
Past performance is not a guide to future returns

Source: Aviva Investors, MSCI ACWI. Data of December 31, 2022.

Principle 2: Look for productivity and persistence

After discerning the trees from the forest, we need to identify the good ones from the bad. Here, ancient wisdom applies: *You shall know them by their fruit*. A common misconception is that profitability tends to ebb and flow. However, when applying a cross-section analysis of return-on-equity, a clear pattern emerges. Good companies tend to stay good, and vice versa. It is rare for companies with low profitability to transform into structurally higher-returning businesses.

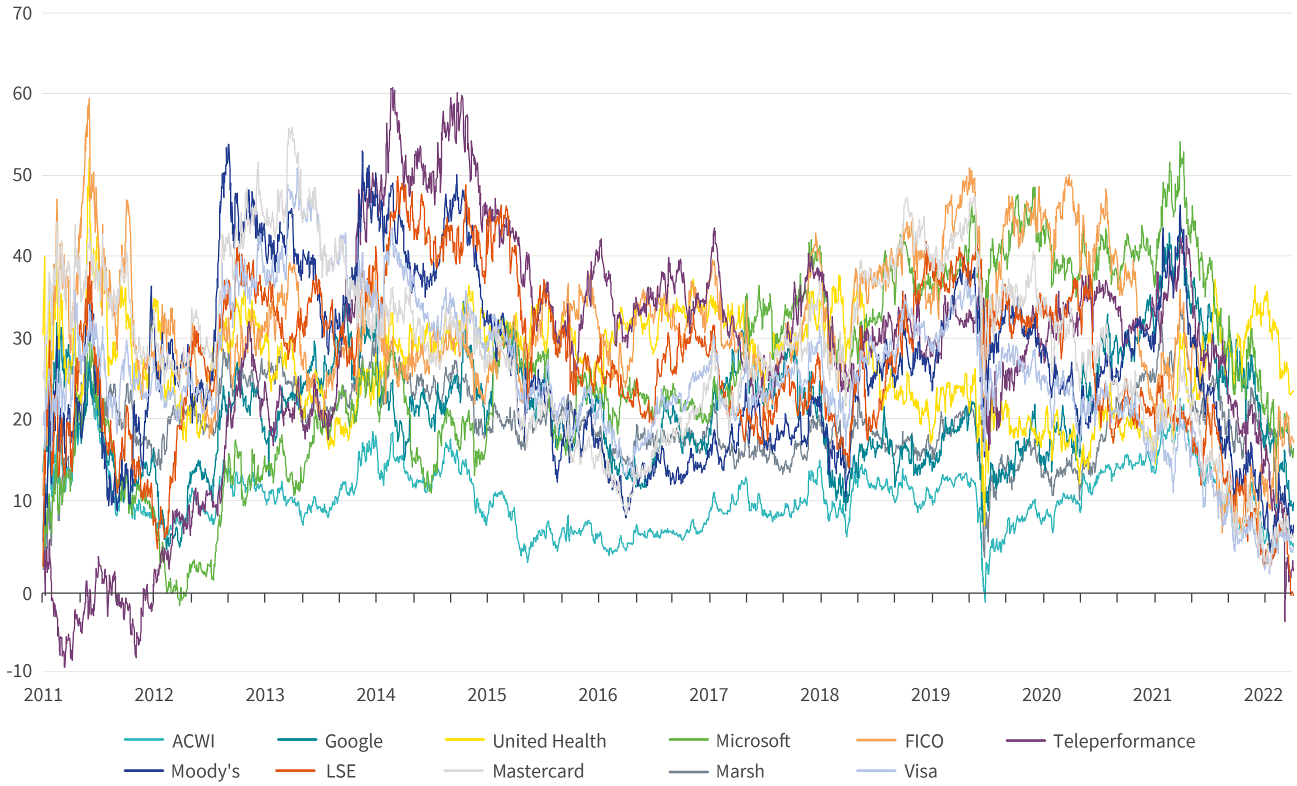
Figure 8. **Good companies tend to stay that way**



Note: December 31, 1992 to December 31, 2013.
Source: Bloomberg, Aviva Investors, S&P 500 constituents. Data as of February 28, 2022.

Share prices follow business values over time. Unsurprisingly, we also find empirical evidence of performance persistence when looking at share prices. Looking at the returns for the MSCI ACWI over the past decade, we can find examples of sustained outperformance. Some companies have delivered alpha over a three-year period regardless of when you invested (Figure 9). Without knowing anything about these businesses, we can tell something special must have happened.

Figure 9. **Persistence of returns (per cent)**



Past performance is not a guide to future returns

Note: Rolling 3-year returns.

Source Aviva Investors, MSCI ACWI. Data as of September 30, 2022.

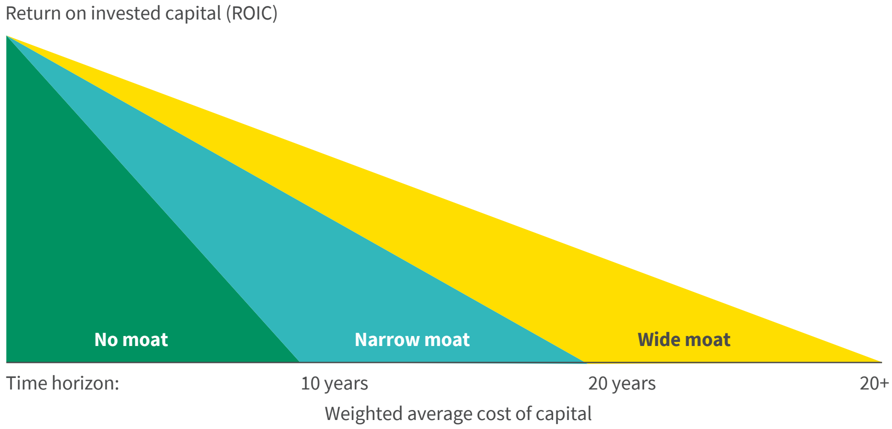
Long-term performance is driven by the ability to grow cashflows. We believe that by focusing on "productive companies" – those that can deliver large and persistent free cashflow/ earnings per share growth – investors have a better chance of tilting the odds in their favour.

Principle 3: Focus on durability

In their search for sustainable and growing cashflows, equity investors often focus on companies with a sustained competitive advantage. Many like to refer to the concept of "economic moats", popularised by Warren Buffett in the 1980s – the idea being that companies possessing certain qualities or characteristics maintain their competitive advantage and profitability for extended periods of time.

Examples of such characteristics would be efficient scale and cost advantages, providing the ability to produce products and services at a lower cost than competitors and enjoying higher margins as a result. Other aspects investors may consider are switching costs (how expensive it is to move to a competitor's offering) as well as intangible assets such as brand, patents or licenses. These also help reinforce the durability of a business, further enhancing the "moat".

Figure 10. **Durable excess returns create value**



Source: Morningstar, September 29, 2022.[3]

For investors, finding companies that generate returns above their cost of capital is a key starting point, but ultimately what drives sustained value creation is the ability to do this consistently over long periods. It is less about the magnitude of companies' profitability or productivity but more about the length of time they are able to maintain it that matters.

Investing in durable companies can also result in a portfolio with lower turnover – there are lots of examples of companies in more cyclical industries able to generate high returns or cashflows for a period (airlines or auto manufacturers, for instance). But inevitably these returns tend to dissipate quickly when the cycle becomes less favourable. Investing in these types of companies requires the skill (or perhaps luck) of timing the market, a gift few, if any, managers possess.

By taking away the timing element and simply focusing on where there are durable competitive advantages and being patient in our investment horizon, we believe we give ourselves the best opportunity to deliver attractive and persistent risk-adjusted returns.

Principle 4: Shift from linear to exponential growth with modern moats

Sustained competitive advantages are paramount in ensuring long-term durability. However, not all competitive advantages are created equal. While most competitive advantages, or economic moats, are designed to keep competitors away, network effects enhance both the durability and growth profile of a company. In fact, they change the paradigm completely.

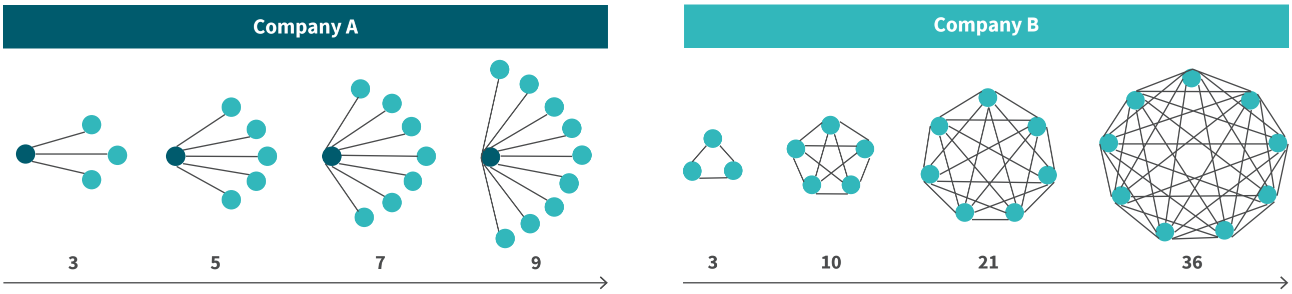
Network effects exist when new customers add to the experience of existing customers. The more successful a company is, the more successful its customers are, creating a virtuous and perpetuating cycle. From search engines to social networks, stock exchanges to discount clubs, network effects allow for economies of scale to be shared by all stakeholders. With large-scale adoption, customers often become the most powerful advocates for a product or service, which makes disruption difficult.

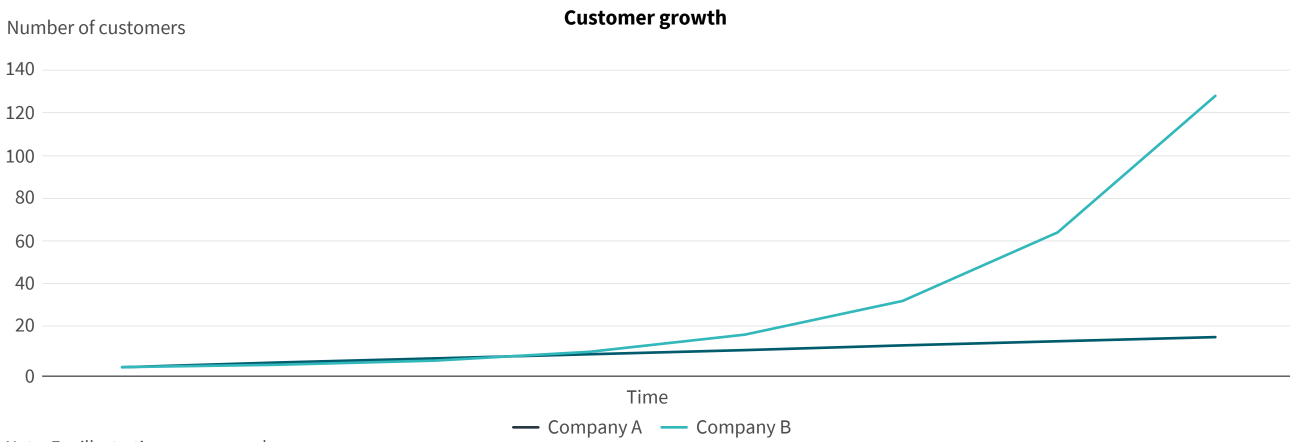
> Network effects enhance both the durability and growth profile of a company

Network effects, or modern moats, are not only more durable, they allow for exponential as opposed to linear growth. Take the example of a traditional clothing manufacturer. In Figure 11, this manufacturer (Company A) starts by selling to three customers. It successfully adds two customers and two more and so forth, reinvesting in its brand and gaining economies of scale, allowing it to continue to grow long term. While this business model might be durable, it ultimately faces diminishing rates of return as a function of its size.

In contrast, a company benefitting from network effects can achieve accelerating rates of return as it grows. Company B, a payments network, profits from the interactions between customers and merchants it facilitates. Each additional customer adds to the strength of the network, but also allows the number of interactions to increase exponentially.

Figure 11. **A framework for modern moats**





Note: For illustrative purposes only.
Source: Aviva Investors, March 2023.

The paradigm shift network effects facilitate also strengthens other competitive advantages. Take Alphabet, for example. Leveraging its competitive advantage in innovation and artificial intelligence, the company has utilised its network effect in Google Search to build a total of nine different platforms with over a billion users, from mobile to video to maps.

Network effects are most associated with the technology sector as the digital age has accelerated their prominence. But they can be found across various industries. When combined with the strengths and idiosyncrasies of individual industries, they straddle the spectrum of growth and durability.

Figure 12. **Types of networks**

	Networks	Example
Freeform	Customers and suppliers have open access on the network	Payment systems
Service	Network infrastructure enabling interactions	Consumer credit rating agencies
Referral	Endorsement of the network by existing participants	Private banks
Captive	Growth enablers with high barriers to exit	Discount clubs

Source: Aviva Investors, February 2023.

Principle 5: Get real on valuations and insist on a margin of safety

Fundamental analysis is the discipline of determining the intrinsic value of a company which, simply put, is the cashflows a company is expected to produce between now and doomsday, discounted back at an appropriate rate. As a result, the discounted cashflow (DCF) model is the pre-eminent tool used to estimate value and ultimately make investment decisions.

DCF model

Present value of discounted cash flows

$$PV = \frac{CF_1}{(1+r)^1} + \frac{CF_2}{(1+r)^2} + \frac{CF_3}{(1+r)^3} \dots \frac{CF_n}{(1+r)^n}$$

What is less apparent is the bulk of the output of the model is driven by the estimate of terminal value, in other words the value of the business into perpetuity at the end of the forecast period. Terminal values can make up over 75 per cent of the value of a five-year DCF and 50 per cent of the value of a ten-year DCF. And yet, the inputs of discount rates and terminal growth rates are both subjective and unobservable. This makes it more useful as a philosophical exercise than a scientific one, especially for investors who aim to persistently outperform over rolling three-year periods.

Decisions based on intrinsic value need three additional levels of scrutiny to supplement the usefulness of the tool:

1. Focus on the durability of the business model and judge the ability of the company to grow cashflows, preferably exponentially, for decades. Principles 1 – 4 are paramount in making this judgement.
2. Sense check the outputs using a medium-term framework with observable and more scientific inputs.
3. Insist on a margin of safety or a discount sufficient to compensate investors for the fact the future will invariably look different to current expectations.

To sense check the intrinsic value estimate of the DCF model, the inputs can be restated in terms of prospective returns. The drivers of returns are the cashflows the company is expected to produce, the growth in those cashflows, and the valuation multiple ascribed to those.

This variation of Gordon's dividend growth model was first derived by Grinold and Kroner and is useful both in terms of its application (as all three inputs can be observed through time, unlike perpetual growth rates) and its ability to be applied across different types of business models (required rates of return are an output as opposed to a subjective input).

Grinold Kroner model

$$R = \underbrace{\frac{D}{P} - \Delta S}_{\text{Income yield}} + \underbrace{i + g}_{\text{Earnings growth}} + \underbrace{\Delta PE}_{\text{Repricing}}$$

The framework also allows investors to frame the drivers of return with a degree of certainty. The level of cashflow, as expressed by the income yield, a company is expected to produce can be estimated with more confidence than ascribing an exit multiple, as expressed by the returns from repricing.

Understanding this allows investors to make decisions based on prospective returns and the level of confidence in their estimate. In the DCF model, the degree of certainty is incorporated in the discount rate and terminal growth rates (the most subjective but also most material inputs to the model).

The combination of a common prospective return framework and deep understanding of the durable competitive advantages underpinning our estimate of intrinsic value allows a powerful combination of the art and science required for investment decisions.

Even so, we must acknowledge the future is uncertain. Therefore, a sufficient discount, or attractive prospective return, must be demanded in all cases. This way of thinking introduces a natural contrarian disposition as lower prices represent a greater margin of safety (and therefore lower risk) as well as higher prospective returns. The challenge is being disciplined enough to buy when others are selling and vice versa and staying true to our process. This stance demands as much fortitude of the stomach as it does integrity of the mind.

The challenge is being disciplined enough to buy when others are selling and vice versa

References

1. Morningstar Global Equity Blend Peer Universe. Data as of December 31, 2022.
2. An upside capture ratio over 100 indicates a fund has generally outperformed its benchmark during periods of positive returns for the benchmark. Meanwhile, a downside capture ratio of less than 100 indicates a fund has lost less than its benchmark in periods when the benchmark has seen negative returns.
3. 'Morningstar equity research methodology', Morningstar, September 29, 2022.

Key risks

The value of an investment and any income from it can go down as well as up and can fluctuate in response to changes in currency and exchange rates. Investors may not get back the original amount invested.

Emerging markets risk

The strategy invests in emerging markets; these markets may be volatile and carry higher risk than developed markets.

Derivatives risk

The strategy uses derivatives; these can be complex and highly volatile. Derivatives may not perform as expected, which means the strategy may suffer significant losses.

Illiquid securities risk

Certain assets held in the strategy could, by nature, be hard to value or to sell at a desired time or at a price considered to be fair (especially in large quantities), and as a result their prices could be very volatile.

Concentration risk

The strategy invests in a small portfolio of securities. Losses from a single investment may be more detrimental to the overall strategy performance than if a larger number of investments were made.

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